BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Master of the Application regarding the Conversion and Acquisition of Control of Premera Blue Cross and its Affiliates,	)	Docket No. G02-45

Adjudicative Hearing
May 12, 2004
Day 7
(Pages 1453 - 1707)
Tumwater, Washington

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MS. DeLEON: Thank you, Your Honor. The OIC staff would like to call Martin Alderson-Smith, please.

MARTIN ALDERSON-SMITH, having been first duly sworn by the Judge, testified as follows:

DIRECT EXAMINATION

BY MS. DeLEON:

Q. Please state your name for the record.

A. My name is Martin Alderson-Smith.

Q. Where do you currently work?

A. I work at the Blackstone Group in New York.

Q. Could you please summarize your educational background, please.

A. Yes. I have an MA from Oxford University, which I received in 1979. I also have an MBA from the Harvard Business School. Since that time, I have worked at the First Boston Corporation in New York and London for eight years, and I have also worked at the Blackstone Group for approximately 12 years.

Q. What do you do at the Blackstone Group?

A. I am in the corporate advisory mergers and acquisitions area of Blackstone and have been in that group in New York for approximately the last 10 or 11 years.

In that group, I specifically look after financial institutions, notably life and health insurance companies. And within the life and health insurance arena, I spend a lot of time working on demutualizations and conversions.

Q. Could you briefly summarize your experience on working with demutualizations and conversions?

A. Yes. Generally, I spend most of my time working for state insurance commissions and Commissioners, overseeing and regulating the demutualization or conversion of various life and health companies.

I have worked very closely with the state of New York on the demutualizations of John Hancock, Metropolitan Life, Prudential, Principal Financial and Provident. I have also worked with the state of Iowa on Principal Financial, with the Commonwealth of Pennsylvania on Provident.

I am also working with the state of New York currently on the sponsor for demutualization of Security Mutual.

On the conversion side, I worked from 2001 to 2003 on the proposed sponsored conversion of Blue Cross/Blue

Shield, Maryland, Delaware and Washington, DC, known as CAFOs.
Q. Did you prepare prefiled direct testimony for this proceeding?
A. I did.
Q. Did you also assist in the preparation and submission of the Initial Report on Valuation and Fairness by the Blackstone Group, dated October 27th, 2003?
A. I did.
Q. Did you also assist in the preparation and submission of the Supplemental Report Review of G-10 and Equity Incentive Plan, dated 11/24/03 by the Blackstone Group?
A. I did.
Q. Did you also prepare and submit a Supplemental Report on the Valuation and Fairness by the Blackstone Group, dated February 27th, 2004?
A. I did.
Q. Thank you. Are these reports incorporated by reference in your prefiled direct testimony?
A. They are.
Q. Did you attach a curriculum vitae to your prefiled direct testimony?
A. I did.

Q. Mr. Alderson-Smith, do you adopt all of your prefiled direct testimony in this matter?
A. I do.
MS. DeLEON: Your Honor, Mr. Alderson-Smith's adoption of his testimony previously filed and served in this matter, we would move for the admission of Exhibit S-7, which is his curriculum vitae, and S-39, which is his prefiled direct testimony. The reports have been previously admitted already.
MR. MITCHELL: No objection.
MS. McCULLOUGH: No objection.
JUDGE FINKLE: Admitted.
Q. Mr. Alderson-Smith, could you please tell us what your area of expertise was in preparing these Blackstone reports?
A. Yes. As Mr. Koplovitz mentioned yesterday afternoon, he and I worked very closely in the preparation of a number of these reports. And within the overall scheme of work, where both of us helped each other out on a number of areas, my particular area of expertise was looking at the Form A documents, which included the voting rights and divestiture agreement, the registration rights agreement, and also the benefit compensation plans.

My specific area was to examine these documents and to look at potential modifications and areas to change that may ensure that we would be able to write a fairness opinion, at the appropriate time, on the fairness of this transaction to the policyholders and the public.

Q. I would like to have you focus your attention on the voting trust and divestiture agreement. Why is it Blackstone suggested that the Washington Foundation be permitted to vote on transactions that result in Premera's owning less than 80 percent of the pro forma company, versus the 50 percent that is currently vetoed?

A. The logic behind modification is that in the current corporate environment we believe that the Washington Foundation needs some additional voting power, free voting power, when it comes to very major transactions, particularly stock transactions, where Premera, for example, may issue large amounts of its own stock to acquire another company.

In many of these situations, it may well be that, even though Premera ends up as more than a 50 percent owner of the resulting combined entity, the shareholders of Premera may not any longer be in control of that entity, it may well be that the shareholders of the acquired entity, through a reverse takeover, may end up being in control.

And, therefore, we are very anxious to ensure that when significant amounts of stock are issued in such a scenario, that there is the ability of the Washington Foundation to be able to vote on those transactions as a free vote.

Interestingly enough, the New York Stock Exchange rules indicate that when a company issues more than 20 percent of its own shares as new shares, a vote is required by that company. And so we are using that as a guideline to modify and to enhance the flexibility and the governance rights of the foundation.

Q. Why has Blackstone suggested that Premera accept one of the three nominees from the Washington Foundation for the company's board of directors.

A. We are concerned now that we have been granted a board seat on Premera's board -- and this is when I say we, I apologize, I should say when the Washington Foundation is granted a board seat on the Premera board -- we think that it is important that that Foundation has a great deal of say in who that board member should be.

During the course of discussions in November, December and January, of this year, there were numerous debates in terms of the sort of qualifications that that board member should have. And I think all of the parties worked, quite successfully, to stipulate the sort of qualifications that the Foundation nominee for the Premera board should have. Those are quite stringent qualifications. They include experience on a public company board or work for a major investment bank accounting firm, management consulting firm, of national repute.

We also have flexibility in terms of further modifying those qualifications to ensure that the sort of member is ideally suited to the Premera board. Given that, we are very concerned that of the three nominees that we would put forward, Premera has the right to veto every single one of those three. We would believe that at least one of those three should be acceptable, and therefore we are very concerned that the net result of us having all of our nominees vetoed, and having to go back to the drawing board to find new nominees, is problematic.

Q. Why has Blackstone suggested that the provision stipulating that the Washington Foundation's rights to nominate a member to Premera's board terminate after five years and that would be problematic?

A. That would be problematic. We understand that this is a Blue Cross/Blue Shield Association issue, just as a preface to this particular point. We believe that that could be a problem, in that, the Washington Foundation, after five years, could end up owning as much as 50 percent of this company.

Given the divestiture and divestment guidelines in the voting trust agreement, we do note that due to blackout periods and other delays, it could be that Washington will still own a very, very material portion of the Premera equity, and that situation could exist for longer than five years. It could exist up to seven years before Washington is below the 20 percent level.

Therefore, our suggestion is to have not only a time limit but also a threshold of ownership. So that if the five-year time limit had expired, and still the Washington Foundation owned more than a certain threshold of shares of Premera, that it would still be appropriate for the Washington Foundation to have a representative on the board of Premera.

Q. Now, why has Blackstone suggested that the divestiture deadlines apply separately for the Alaska and Washington Foundations?

A. This is an issue that has really arisen as a result of discussions that took place during the winter of 2003 and the spring of 2004. The problem really arose from what we consider to be a beneficial outcome of having now two Foundations rather than one.

At the initial periods of discussion, a divestiture schedule was detailed on the assumption that we only had one Foundation. Now that we have two Foundations, there is a concern that there is a potential for conflict between those two Foundations in terms of how the divestiture schedule works. This is a particular and primary concern that we have.

I think that we have less concern about the overall speed of the sell down, except for one point that we will come down to a little later. But the interaction of the two Foundations, in terms of how the shares are sold, is quite problematic to us.

For example, if Washington does not sell down as many shares as it should in its divestiture timeline, then there is an obligation for Alaska to accelerate its timeline, and that also happens on a reciprocal basis. This could lead to potential friction between the two Foundations, which we do not think would be beneficial to any party.

Q. It has been talked about that some of these requirements are levied by the Blue Cross/Blue Shield Association. Why has Blackstone suggested that the voting trust and divestiture agreement be terminated if the company were to lose the Blues mark?

A. First of all, I would agree with you, many of the elements of the voting trust and divestiture agreement really stem from the Blue Cross/Blue Shield Association guidelines or particular remits in this conversion.

If for -- what I would consider to be a very unfortunate event taking place -- namely, the Premera were to lose the marks, and it is obviously very difficult for us to imagine the loss of those marks as anything other than a disappointing, in fact, a disastrous outcome. If such a situation were to occur, we believe that certain of the restrictions -- in terms of the ability of the Foundation to increase its level of governance, and also the ability of the Foundation to significantly reduce, if appropriate, its sell down of the shares of Premera -- we believe that such elements, we think, would be beneficial to the Washington Foundation, to manage what could be a very difficult period of time.

Q. Are there any provisions of the voting trust and divestiture given that might be appropriate between a publicly-traded company and a significant shareholder?

A. There may be a number of provisions within a modified voting trust and divestiture agreement that would be appropriate. Obviously, we would be prepared to discuss those elements. There may well be lock-out periods that would still be appropriate for the Foundation to continue to hold shares.

There may even be appropriate discussions that could take place on the divestment of those shares on a different timeline or a different schedule. In addition, there may be certain changes in governance that might be appropriate and would be -- and should be discussed.

I don't think -- as Mr. Koplovitz testified yesterday afternoon, I don't think that it would necessarily be the case -- and I am not even sure that the agreement should be modified to allow for a complete takeover of Premera by the Washington Foundation.

I think that may actually be problematic for a whole series of reasons, including the maintenance of an appropriate stock price. It may scare investors -- both at the time of that takeover, as well as at the time of an IPO, and clearly that's something that none of us want to have happen. But it may be appropriate therefore to modify this agreement to make it more appropriate to the changed circumstances of the loss of mark.

Q. I would like to have you turn your attention to the registration rights agreement. In a situation where the Washington Foundation piggy-backs on a company registration, should it have input into the pricing decisions?

A. This is, I think, a relatively small point, in that, clearly in a situation where Washington goes for a demand registration to sell down its stock, and Premera enters into that registration right as a piggy-back, clearly there is a need for Washington to continue to have some influence and certainly be consulted on the level of price, the level of demand for those shares.

And, in exactly the same way, we believe that when there is a Premera sale and Washington comes in as a piggy-back on the registration of the company, again, there should be some -- perhaps more limited -- but nevertheless some clear degree of consultation.

Q. Perhaps you could give us a brief explanation of what a piggy-back is.

A. Yes. A piggy-back is a situation where one constituent, one shareholder, wishes to register its shares. And clearly a registration of shares, as I think was discussed yesterday by Mr. Steel, is a -- probably a more efficient method of putting shares out into the market, than simply selling them to a market maker on Wall Street.

A registration would then require an SEC document, it would also generally need a road show, which is a discussion with potential investors, when the company would go out and discuss its prospects with a wide range of potential investors. So there could then be an orderly sale of those shares to new investors, usually at a fixed price.

That is a very expensive and very time-consuming process, it is a major burden on the company. And therefore, it is often the case that when you have such a registration process going on, other major shareholders who may wish to sell large blocks of shares, have the right to go along with the shareholder who has in fact initiated this process. That going along is effectively called a piggy-back.

Q. Why is Blackstone concerned about the level of independence of Premera's board of directors?

A. It is an interesting situation, in that, at the moment we have a clearly heightened awareness of good corporate governance and good corporate practices in the board room. There has been, obviously, a lot of news in the newspapers and media about independent directors failing in their duty to look after all of the shareholders of the company that they represent. There have been examples as well known as the New York Stock Exchange to Tyco to Adelphia, many, many different situations.

In many of these situations, the directors were not in fact as independent as they perhaps should have been. With the benefit of 20/20 hindsight, certain independent directors now don't look as independent as perhaps people thought they were before these incidents took place.

It is, therefore, critically important that the independent directors of Premera, not only are independent, but are also seen to be independent. One of the concerns we have, is that when we look at the independent qualifications -- which, by the way, are New York Stock Exchange qualifications -- so these are ones that are practiced at the moment by different boards.

But when we look at those qualifications and those guidelines, we are very concerned about the two percent test, which says, that if a director is an employee of a company that represents more than two percent of Premera's revenues -- and that is also a reciprocal on the company's -- of the director's company's revenues, then -- so long as it is less than two percent, that director would be considered to be independent.

Our concern is -- and I think we went through the arithmetic yesterday with Mr. Steel -- our concern is that major customers of Premera, perhaps representing as much as 56 or 57 million dollars in revenue, could still be considered to be independent directors.

And therefore, our suggestion is that -- at the moment the way that the bylaw is currently written and currently drafted, is that it is the greater of two percent or one million dollars as being the standard for not being independent -- our belief is it should be the lesser of two percent, or one million dollars, which would therefore allow people who have major business relationships with Premera not to be independent. They could become non-independent directors, they could become clients or customers who are seen as inside directors. But in terms of independent directors, we think it is very important that these people really are independent.

I agree that this will narrow the pool. It means that we won't be able to have major customers in Premera as directors. It means that maybe we won't be able to have certain of the physicians working within this service area as directors. That is, I think, looking at the balance of the risks and the benefits, a benefit -- a net benefit to Premera and to all of its shareholders.

Q. Did you have a chance to review the Unallocated Shares Escrow Agent Agreement?

A. I did.

Q. And what are Blackstone's concerns regarding that

agreement?
A. We have a couple of concerns on the USEA, as we call it. Really, this agreement was created quite quickly as a reaction to the inability of the state of Alaska and the state of Washington and to the inability of the various consultants working for those states, including Blackstone, the inability of those various groups to come to a clear agreement in terms of the allocation of shares of ownership of this company between the two states.

So I would like to just sort of say, clearly this is not a situation that was one created by Premera. Premera, in fact, drafted language to try and deal with a problem that came from really an inability of the states to agree on a clear and specific allocation of shares.

This agreement was quite quickly put together. We do not believe it has had enough review or discussion. It was put together really at the last minute. And as a result, we have a couple of concerns. There are a few minor drafting concerns that we have, but there are a couple of really significant concerns that we have with this agreement.

The first concern has to do with the potential sale of shares in the IPO. As Mr. Koplovitz testified yesterday, it may well be that the Foundations either do wish or do not wish to sell shares in the IPO. That will be a decision that should be made much closer to the IPO when we fully understand what the appropriate size of the IPO should be, what the appropriate split of shares between primary shares sold by the company and secondary shares sold by the Foundations should be. Also, what the use of funds is going to be, what are those funds going to be used for, either by Premera, particularly, or by the Foundations. So it is a decision that we really don't feel capable of taking until much closer to the IPO.

However, in the USEA, there is the stipulation that if the Foundations do not sell 10 percent of their shares in the IPO, then the escrow shares will be sold up to a total of 10 percent for each Foundation. Which, to some extent, removes from the two Foundations the flexibility that Mr. Koplovitz was discussing yesterday. That's probably the first point.

The second point, again, is really in the situation of governance. When we have a situation where the states of Alaska and Washington can't necessarily agree on an appropriate course of action for voting the escrow shares during the period of a free vote, in that situation, the vote in fact is taken away from both the

Foundation for Washington and the Foundation for Alaska, and mirrors the vote of the independent directors. Effectively the vote is taken away from the Foundations and given to the independent directors. We believe that some work needs to be done on that, because we feel that removing that right to vote on important transactions could be problematic.

Q. Now, of all the changes and modifications that you have discussed today and that are in the Blackstone report, would the stock market react negatively to any of these in your opinion?

A. Obviously, this is an issue that we have had a great deal of discussion about. Because it is a very tough call to try and quantify the price and value implications of any of these particular issues.

I would like to just carve out one right away, and that is, we are not in any way advocating that the company, or we, or any other party, should be aiming to lose the Blue Cross/Blue Shield mark. So, obviously, if for example, there was a situation where the Blue Cross/Blue Shield Marks would be lost, I could say with fairly strong degrees of certainty that would have a serious negative evaluation impact.

So I just sort of carved that one out for a moment, and move to the -- all of the none Blue Cross/Blue

Shield Association issues. Our belief is that none of those would have material impact in terms of price and value increase, or price and value decrease.

What most of those provisions try to do is to ensure that the Foundation and the policyholders, as well as all the shareholders in many of these instances, have the maximum flexibility with regard to the disposition of the Foundation shares, and also have appropriate governance rights to ensure that the Foundation's position is taken note of in discussions, that it doesn't dominate board proceedings, but nevertheless, is an influence in some of the more important decisions that are made by Premera.

And I think just as -- just sort of one final element on this, I think it is fair to say, just looking at the testimony of Mr. Koplovitz yesterday, as well as various discussions that we have had with the company over the last five to six months, there has obviously been an enormous amount of progress that's been made in terms of dealing with large numbers of issues on the Form A filing.

And, clearly, the revised Form A filing, particularly, as revised for one or two other additional elements that have been put into various direct testimony over the course of the past few weeks, this revised Form A filing is dramatically and substantially better in terms of striking the right balance between maximizing value for the Foundation, as well as guarding flexibility and governance rights for the Foundation than the first Form A filing of October 2003.

Q. As currently construed, do the documents allow for a fair market value to be transferred to the Foundation?

A. We believe, as currently construed, there are still problems in terms of fair market value and fair value to be transferred to the Foundation.

MS. DELEON: I have no further questions.

CROSS-EXAMINATION

BY MR. MITCHELL:

Q. Good morning, Mr. Alderson-Smith.

A. Good morning.

Q. My understanding -- and I would ask you to confirm this -- is that the value of Premera -- and, more particularly, the value of the stock of Premera that is proposed to be delivered to the Foundation will be established by the market after the IPO. Is that your understanding?

A. That is my understanding.

Q. Now, as I understand it, one of the tasks that Blackstone has been given is to look at whether the

transaction, taken as a whole, is fair to the public from a financial point of view; is that correct?
A. That is correct.
Q. And this question of fairness, as you have considered it, involves three elements, does it not? Namely, the value received by the Foundation, the degree to which the Foundation can exercise control over its primary asset, namely, the shares, and the flexibility enjoyed by the Foundation in disposing of the shares?
A. I think that's a good summary.
Q. Now, as I understand it as well, Mr. Alderson-Smith, those three objectives are intention. That is to say, that the value to be received by the Foundation is somewhat at odds with the question of flexibility and control. Is that not true?
A. That is true. It is a balance.
Q. And more specifically, the degree to which the Foundation can exercise control over its shares can adversely affect the value of those shares, because of the concerns of the other investors in the market; is that not true?
A. I think the concept we have here is if we give unbridled power to the Foundation and unbridled flexibility to the Foundation, in terms of selling down its shares, allowing it to sell down its shares whenever

it feels like it, that will have potentially negative consequences for the value of the stock.

And it will have potentially negative consequences for the value of the stock because new investors will be very wary of an investment that is -- or a company that is dominated by one shareholder, where there is no clear limits on the power of that shareholder to exercise control, and there are no clear limits on the ability of that shareholder to drop shares into the market whenever that shareholder may feel like it.

So I think, absolutely, it is clearly a matter of balancing in those three potentially conflicting forces that is one of the jobs that we are confronted with.

Q. There is another three-factor balance at play here I believe as well, is there not, Mr. Alderson-Smith? Namely, to balance the desire to give the Foundation more flexibility, the desire to provide for the maximum value of the shares, and finally, to balance what would be acceptable to the Blue Cross/Blue Shield Association?

A. Obviously, the element of the Blue Cross/Blue Shield Association has to be taken into account as we look at this balance.

Q. And I believe your direct testimony is consistent with your view previously expressed that the loss of the Blue Cross/Blue Shield mark and the other elements that go with those marks in terms of reciprocity with other plans -- the National Blue Card Plan and the like -- and the potential award of that mark to a competitor in the market, would result in a major diminution of value to the Foundation and to the people of Washington. Is that not true?

A. We believe that there would be potentially serious negative valuation consequences.

Q. And because of that, I believe you would agree -- would you not, Mr. Alderson-Smith -- that to maintain the mark is of critical importance, from a value standpoint and in terms of the protection of the subscribers of this company?

A. We believe that the maintenance of the mark is a very important element in this company.

Q. And the company, of course, shares that assessment, does it not?

A. I believe so.

Q. Indeed, the company has indicated that it will not proceed with this transaction if the price of proceeding would be to lose the mark, and with it the benefits to the subscribers of Premera Blue Cross?

A. That sounds like a very sensible and appropriate stance.

Q. So, just to close the loop on a fairly obvious point, but would you agree with me that if the transaction does not proceed, there will be no value whatever delivered to the Foundations?

A. I would agree that if the transaction does not proceed, the Foundations would not exist. And, therefore, no value would be transferred to them.

Q. If the transaction does proceed, would you also agree with me, Mr. Alderson-Smith, that the value impact, if any, of the restrictions upon the Foundations -- in terms of exercising control over their stock and exercising control over the governance of new Premera -- pale in comparison with the value impact of losing the Blue license?

A. We have not quite looked at the -- at that equation in that way. We have rather studied the additional flexibility or the additional -- what we consider to be important governance elements, which don't necessarily have dollars and cents value in the same way. They have important qualitative values to the Foundation. Against that, we would say it is likely that there would be a strong negative quantitative loss of value if the Blue marks were lost.

Q. And to pursue the issue of value with respect to the first element you mentioned a bit further, would you agree with me, Mr. Alderson-Smith, that the restrictions upon the Foundations, in terms of exercising control over the company or having flexibility to dispose of their stock, those restrictions do not follow the stock into the hands of any investor that might buy the stock from the Foundations?

A. That is right. They are entirely unencumbered upon transfer out of the Foundation.

Q. So it would be erroneous, would it not, to conclude that those restrictions would have any material impact on the value of the shares upon their transfer to willing investors?

A. It would have no value benefit to the shareholders upon their transfer out, it would only have value of a qualitative nature while they remained inside the Foundation.

Q. So, with these considerations in mind, Mr. Alderson-Smith, and in particular the consideration of the importance -- the vital importance to the company and to the value of its shares and the maintenance of the Blue mark, what would it take for Blackstone to be able to opine that the transaction is fair to the public from a financial point of view?

A. We would like to see some more discussion -- clearly, we have already noted the discussions that have taken place in March of this year between the company and Premera. We would like to see some more discussions take place to ensure that the Foundations, who are ultimately the interests that we -- the interests of whom we are trying to protect -- are protected to the best possible degree in any transaction if such a transaction could go forward.

Q. We have a difficulty at this stage of the game, Mr. Alderson-Smith in that the parties' discussions have reached a point where a proposal has been put forward to the Commissioner for a decision. And the Commissioner has to determine what, if any, changes need to be made to the proposal in order to assure -- at least in your judgment -- that it is fair to the public from a financial point of view.

So I must ask you, what is the irreducible minimum that you would demand as the price for a fairness opinion?

A. And, at this stage, I cannot give you that irreducible minimum. Clearly, this would be a topic that would be discussed in the context of all of the changes that we believe should be made and that we have set out in our report of February 27th.

Our belief is that a series of those changes need to be examined. And it will be a combination of those changes -- perhaps not all of those changes and

modifications -- that will allow us to render an opinion that this is in fact a fair transaction to the Foundations and to the public here in Washington.
Q. Now, with respect to your examinations and analysis of the question of fairness, Mr. Alderson-Smith, you have assumed, have you not, that Premera is already owned by the public?
A. Effectively, we have made that assumption. It is -- we have been sort of quiet on that assumption. It is not one that has been stated in our reports, but it is an underlying assumption that Premera is effectively owned by the public.
Q. And am I correct in my understanding, Mr. Alderson-Smith, that Blackstone has not undertaken to establish the validity of that assumption?
A. That is correct, we have not undertaken to establish the validity of that assumption. That is an assumption that we have taken as a given.
Q. You have heard Mr. Steel's testimony, have you not?
A. I did.
Q. You understand there is some considerable doubt as to whether the assumption is valid?
A. I did listen to Mr. Steel's testimony on that point yesterday.
Q. Would you agree with me, Mr. Alderson-Smith, that if

the public does not now own a hundred percent of Premera, there will be no basis to conclude that the proposed transaction is unfair to the public from a financial point of view?
A. Can you ask that one again? I am sorry.
Q. Certainly. If the public does not now own Premera, is it not the case that there would be no basis for you to conclude that the proposed transaction is unfair to the public from a financial point of view?
A. So I think the point -- just to summarize, I think what you are saying is effectively if we assume that the public don't own this company now, and therefore they get a dollar in the mail next year, that is -- a dollar is better than nothing, and therefore it is clearly fair?
That would be, I think, a reasonable supposition to make. Obviously, that does not necessarily square with the underlying assumption that we have made on this transfer.
Q. Yes. And a dollar in the mail doesn't sound like a whole lot, but would you agree, Mr. Alderson-Smith, that 500 to 700 million dollars in the mail would be quite nice?
A. Quite material, yeah.
Q. Now, would you agree with me, Mr. Alderson-Smith,

that the Commissioner needs to consider -- in addition to the interests of the Foundation proposed to be established here -- the potential impact of the transaction, in terms upon subscribers and the insurance-buying public?

A. I think that is clearly an important element. It is not necessarily one of the elements that we have studied in our particular area, but we do recognize that fairness to those constituents is important.

Q. And you would recognize, would you not, Mr. Alderson-Smith, that taking perspective from the subscribers and the insurance-buying public might lead to a rather different evaluation of the few transaction terms that remain in dispute between Premera and the OIC staff's consultants?

A. There may be some difference in emphasis.

Q. I want to turn now to the WellChoice transaction, if I might, Mr. Alderson-Smith. From Blackstone's perspective, is it not the case that the WellChoice transaction offers the most recent, and potentially the most comparable set of documents, by which the transaction terms in this case can be evaluated?

A. Yes. We believe that WellChoice is certainly the most recent -- and along with one or two other precedent conversions -- represents an important benchmark against

which to measure this Premera conversion.
Q. It is comparable in terms of size, it also had as its goal an IPO, did it not?
A. It did.
Q. By the way, you talked about sponsored mutualizations and sponsored conversions. Those are instances in which the goal of the transaction is not an IPO but an acquisition by a third party; is that right?
A. That is correct.
Q. With respect to the transaction terms and dispute -- many of which you remunerated in your direct testimony, Mr. Alderson-Smith -- would you agree with me that nearly all of them involve requests by the states' consultants that go beyond the terms of the WellChoice transaction?
A. There are some of those elements that go beyond the WellChoice transaction. Other elements -- in fact, in the documents and in the terms that we would be prepared to agree to -- in fact, are not necessarily as good as the WellChoice transaction.
But I do agree that there are a number of those elements that are in fact more advantageous, in terms of greater governance or greater flexibility or delivering potentially more value to the Washington Foundation, than the New York Foundations received in the WellChoice

conversion.
Q. And the WellChoice precedent looms large for the Blue Cross/Blue Shield Association, as well as for the consultants, does it not?
A. It is certainly an important precedent, yes.
Q. And are you aware of the fact that the Blue Cross/Blue Shield Association has said that it will not accede to terms that goes beyond those approved in the WellChoice transaction?
A. I have heard that that is a statement that has been made.
Q. So let's take off a few of the items that you talked about this morning, Mr. Alderson-Smith, that do go beyond the terms of the WellChoice transaction.
The first of those is the change-in-control threshold and the free voting on change-in-control proposals that involve 20 percent, versus 50 percent, change of stock ownership.
Is it not the case on that particular point that what Premera has proposed is identical to the WellChoice documents?
A. I believe it is identical to WellChoice.
Q. And with respect to the divestiture schedule that has been proposed by Premera, is it not the case that the overall divestiture schedule is identical to that

which was used in WellChoice?
A. The overall divestiture schedule is identical, obviously subject to there being two schedules versus one in the Premera situation, and also the very small technical detail in terms of the 80 percent, year-one hurdle, which we would, in fact, be interested in having removed. But subject to that, you are absolutely right, they are very similar.
Q. We will come back to that 80 percent issue in a moment. Just to get to the list, the length in time during which the designated members have tenure on the board -- and it is the lesser of five years or five percent stock ownership, that provision in the Premera documents is identical to what has been provided in the WellChoice transaction, is it not?
A. It is.
Q. And with respect to the right of the Premera board members to veto nominees by the Foundation to the Premera board, that provision is identical to the WellChoice provision, is it not?
A. I believe it is, yes.
Q. Actually, I think I misspoke, Mr. Alderson-Smith. Is it not the case in the Premera documents that if Premera actually vetoes the nominees by the Foundations, it must, upon request, explain its reasoning for doing

so?
A. That's right. There is a right of consultation or at least -- not necessarily public consultation -- but at least a requirement to identify some of the elements or some of the concerns that led to the vetoing. That is something that -- that additional consultation is an element which is over and above that that we have identified in WellChoice.
Q. So that's actually advantageous to the Foundations, relative to WellChoice already, is it not?
A. Well, yeah. When you have sort of nixed all of three directors and you tell us why, I guess that is a good thing. But it is kind of problematic in its own right, but I take your --
Q. I think you indicated that the qualifications for nominees were carefully crafted to be stringent. They were actually -- those qualifications were drafted by Mr. Koplovitz, were they not?
A. Who was a very stringent drafter of such requirements.
Q. Among the persons who would qualify under those particular qualifications would be every former partner of Arthur Anderson, is that not true?
A. Yes, it is true.
Q. And also, any person who serves as an executive in a

citrus company in Florida would qualify?
A. So long as that citrus company was a public company. Obviously, the number of citrus companies that are public in Florida are quite miniscule, I would suggest. But the concept, again, is that we and Mr. Koplovitz drafted some requirements. Again, those are requirements where there is some latitude to make them still more stringent.
The thing that was very concerning was that, even with those sort of requirements, there was still an ability to veto nominations, which were particularly problematic.
Q. I think you would agree, would you not, Mr. Alderson-Smith, that having a particular item on one's resume may or may not suggest that one is well-suited to work well with other people in that collaborative undertaking?
A. That is correct.
Q. And in the context of a board that is as active and -- as the Premera board, and does so many things on a committee basis and are critical to the company, is it not reasonable to think that the chemistry of those people is an important issue for the board?
A. The chemistry is perhaps less important than the knowledge and comfort that the Foundation has that it is

being represented by someone who is going to look after that Foundation's interest, that Foundation having a quarter of a billion dollars or more of shares -- at least at the beginning -- in Premera.

And, therefore, it is particularly important that that director is someone who is going to look after the Foundation's interest, but also -- and the Foundation has to fully understand this -- but also represent all of the shareholders of Premera as part of that director's fiduciary duty.

Q. It is an excellent point, Mr. Alderson-Smith. Under the terms of the transaction documents as they exist, the designated member of the Washington Foundation and the Alaska Foundation is not going to be a potted plant. The designated member of the Washington Foundation and the designated member of the Alaska Foundation are to sit on the executive committee, the compensation committee, and the pricing committee of the board, is that not the case?

A. That is the case.

Q. And within the context of committee work, would you not agree with me, Mr. Alderson-Smith, that it is doubly important that the members of such committees be able to work together in order to make sure that the corporation's functions proceed smoothly?

A. It is going to be very important that all of those members work together. It is going to be very important for the board of Premera, it is also going to be very important for the Washington Foundation. Because if that group, those committees, that board, is dysfunctional, that could have deleterious consequences on the value and the ultimate price at which the Foundations can sell those shares.

Q. Just to be clear, Mr. Alderson-Smith, the right to veto nominees of the Washington Foundation does not mean, at any point that, the Washington Foundation will not have a designated member on the board, does it? It only means they must supply an alternative nominee?

A. That's correct. It means they must supply an alternative nominee.

Q. So we have gone through some items that are consistent with WellChoice, beyond which the Blue Cross/Blue Shield Association has said it will not go, and I think we are left with three or four items that you mentioned, Mr. Alderson-Smith.

One, is the survival of the voting trust agreement in the wake of the loss of the Blue Marks. Second, is the definition of independence for board members on the Blue Premera board. Third, is the unallocated shares escrow agreement. The last, the

consultation on pricing. Did I guess those right?
A. Yes. There is, I think, one more in the registration rights agreement. There is consultation on pricing --
Q. You might be thinking of the question of whether there is an obligation to continue with a registration after a company has withdrawn?
A. Yes.
Q. If legally permissible or if practicable --
A. Practicable by the company's thinking, that is correct, that is my final element.
Q. Do you think that with -- with respect to that last element, Mr. Alderson-Smith --
A. Sure.
Q. -- do you think, had Mr. Koplovitz not drafted the legally permissible link in the course of these discussions, that you would even have noticed a difference between that and practicable?
A. I wouldn't like to answer that question.
Q. Let's turn to the unallocated shares escrow agreement for a moment if we might.
A. Yes.
Q. There was something similar to that agreement in WellChoice, was there not -- not an agreement but an escrow arrangement?

A. There was an escrow arrangement in WellChoice, yes.
Q. You would agree, would you not, it is necessary to have an escrow agreement if the parties -- if the states cannot agree upon an allocation of the shares?
A. We think that it is a creative way to deal with the difficulties that we have had in terms of working on an acceptable allocation.
Q. Now, you said that the unallocated shares escrow agreement was sort of a last-minute agreement and suggested that it didn't have the terrible review that the other documents in the Amended Form A received; is that correct?
A. That is correct.
Q. In fact, is it not the case, Mr. Alderson-Smith, that when Premera proposed the unallocated share escrow agreement to the states, they refused to review and comment upon it because they were convinced they could agree upon an allocation?
A. I am not aware of that particular element in the timeline, but I do know that this was very much something that was prepared, finally, at the last minute.
Q. The unallocated shares escrow agreement has within it a clause that allows it to be freely amended by the parties upon common consent, does it not?

A. It does.
Q. Do you have any reason to believe, Mr. Alderson-Smith, that if the agreement is even required -- and I would assume that you agree that it will go away if there isn't an allocation agreement. But assuming the unallocated shares agreement is required, that any issues or concerns about its terms cannot be resolved by an amendment?
A. It can be resolved by amendment by agreement of all of the parties.
Q. On the change-in-control issue, Mr. Alderson-Smith, you mentioned that because of various blackout periods and the like it is conceivable that the Foundations could be holding 50 percent of the shares after five years. Do you recall that testimony?
A. Yes, I do.
Q. Is it not the fact that in prior conversion transactions the divestiture of shares has actually proceeded ahead of the schedule set forth at the outset?
A. I think in some instances the divestment schedule has been faster than mandated in the sell down agreement.
Q. Are you aware of any instance in which after five years a selling foundation has held 50 percent or more of the shares?

A. I am not aware of any situation, certainly in the last many years, when there has been a problem with the shares being more -- a larger number of shares being held by the Foundation than were set out. This is partly, of course, because we have had a remarkably strong series of equity markets over the last many years. Really, throughout the 1990s we had quite strong equity markets. And also the Blue Cross/Blue Shield public companies have generally had a very strong performance.

We are obviously concerned about a time in the future -- which none of us obviously want to have happen -- but a time in the future when it may be that the equity markets -- and Blue Cross/Blue Shield public companies, specifically -- do not have such a good wind in their vacuum in terms of rising stock prices.

Q. The Foundations will have strong incentives, apart from the state of the market, to sell off their shares over the first several years of the divestiture schedule, will they not?

A. They will have some incentives to be able to fund the various healthcare initiatives.

Q. And beyond the need to monetize the shares in order to have funds to provide for health needs -- unmet health needs in the state of Washington and the state of

Alaska, it would be prudent of the Foundations to divest themselves of shares in Premera in order to diversify their stock holdings; is that not true?
A. That might be true if the markets were amenable to that occurring.
Q. Now, you mentioned with respect to the separate divestiture schedule that there was a potential for conflict between the states. And it was the potential for conflict between the states that was of greater concern to you than the overall schedule that is proposed by Premera; is that correct?
A. That is actually correct, yes.
Q. Now, as I understand your testimony, one of the principal concerns about potential for conflict is the cross default provision in the language of the divestiture schedule; is that right?
A. That is right.
Q. The problem is that if Alaska proves obdurate, Washington could pay the price, and vice versa; is that right?
A. That is right.
Q. Now, one potential way to address that issue -- would it not be, Mr. Alderson-Smith -- would be to have a proportional divestiture schedule, that is that both states -- both states and Foundations would be operating

within a common schedule but functioning in proportion to their shareholdings and meeting the same deadlines without cross default?

A. We believe that that may be an interesting line of inquiry, which would solve some of the problems that I mentioned earlier in my testimony.

Q. And if that were done, then if Alaska proved obdurate in terms of selling off its shares, then they would drop into the Excess Shares Escrow Agreement and be handled in that fashion; right?

A. If Alaska proved obdurate, there would obviously need to be ways to deal with that directly with Alaska, without concerning Washington. And obviously if Washington was obdurate, exactly the same mechanism could take place.

Q. And, indeed, there is an Excess Shares Escrow Agreement in the Form A documents designed to deal with just such circumstances, is there not?

A. There is.

Q. You mentioned, with respect to the voting trust agreement and the question of whether it should survive the loss of Blue Marks, that there are a number of provisions in the voting trust agreement that would have value post such an event, and so you would not be fully in favor of just having it disappear altogether; is that

right?
A. Right. I believe that there is some middle ground between ripping up the voting trust and divestiture agreement in its entirety, and modifying it to ensure that certain elements of the agreement, modified, are maintained, while other elements, which could be detrimental to the Foundations, and also detrimental to the -- all the other shareholders could be eliminated.
Q. One of the difficulties at this stage of the game, Mr. Alderson-Smith, is trying to foresee the circumstances in which this -- highly unlikely, but as I think you have described it, potentially disastrous -- event might occur, and to plan for all of those possibilities.
So one solution might be by the parties to discuss -- should this unlikely but unhappy event occur -- potential modifications of the voting trust agreement; is that right?
A. Though the parties have the right to discuss, the obligation to discuss -- I mean, that they would have the obligation to go on to a different basis potentially.
Q. There is nothing in the terms of the Form A documents that would prevent the Foundations from approaching Premera in the event of the loss of the

marks to discuss modifications of the voting trust agreement, is there?

A. I do not believe that there is.

Q. Can you be specific, Mr. Alderson-Smith, and tell me which provisions of the voting trust agreement you would recommend remain in place after a potential loss of the Blue Marks?

A. Yes. I believe that there could be some benefit -- both to the Premera shareholders, as well as to Premera, and potentially even the Foundations -- to have not -- to not allow the Foundations to exercise all of their governance rights, which would otherwise be conferred upon them given their potentially substantial shareholdings in the business.

And therefore, I would suggest that those elements, somewhat modified, could remain in the voting trust agreement. There are some elements, particularly the forced divestment schedule, that we believe is not only potentially damaging to the Foundation, in that it is unlikely and difficult to model future events, but we also think it could be extremely damaging to all the other shareholders.

Q. So if I am understanding you correctly, the voting restrictions are appropriate at that point, but the divestiture schedule might eventually be put on hold; is

that right?
A. That is correct, with regard to the divestiture schedule. With regard to the voting schedule, there may well be some additional rights granted to the Foundations. However, it may be problematic to, in fact, give full voting rights to the -- to those Foundations.
Q. Now, with respect to the divestiture schedule, obviously, at the point that such an unhappy event occurred, there would be no restriction upon the power of the Premera board to grant leave to ignore the divestiture schedule, because it would no longer be subject to Blue Cross sanctions with such an action; correct?
A. That is correct.
Q. And it would obviously be in the interest of the Premera board to do that if the consequence following the divestiture schedule at that point would be to tank the price of the stock; is that not true?
A. That is probably a likely outcome.
Q. I would want to turn briefly to the issue of the standard for independence of Premera board members. As I understand it, Blackstone would prefer to see a standard that looked at the lesser of one percent -- two percent or one million dollars -- as opposed to the

greater of, as followed by the New York Stock Exchange; is that right?
A. That is correct.
Q. Do you think it would be advantageous to the company -- or to its subscribers or to the insurance-buying public -- if a member of the Premera board, who was an independent director, who was an employee of a company with 300 subscribers, would thereby disqualify Premera from going after the business of that company with 300 potential subscribers?
A. Obviously, in that example, it is difficult to see the benefit of going after that piece of business. I understand the potential conflict that that might lead to.
Q. And I believe you acknowledged that the consequence of following Blackstone's suggestion in this regard would be to eliminate from the category of independent board members positions within Premera's service area; is that right?
A. That is correct.
Q. Do you think that the subscribers and the insurance-buying public might actually benefit from having providers on the Premera board who can qualify as independent directors?
A. It is obviously a very tough balancing act between

having subscribers or physicians on the Premera board in terms of the knowledge, the local knowledge that they could bring, as opposed to the problem that they may be not in fact thinking first and foremost of the interest of all the Premera shareholders, but thinking about their own specific relationship with Premera. And that is obviously the concern that we have.

Q. Let me turn to the prospect -- the impact of this conversion upon Premera, if I might, Mr. Alderson-Smith.

Would you agree with me that a company in the position of Premera, with a stronger capital position, may be able to take a longer term view of the prospects of a particular market than a company that is capital constrained and for that reason may be forced to pull out?

A. Yes. A company with more capital is generally better than a company with less capital, in terms of taking advantage of new opportunities.

Q. Would you agree as well that capital raised through the proposed conversion and IPO will give Premera flexibility and financial planning and prepare it -- allow it to prepare itself for expected or unexpected events in a fashion that would otherwise not be possible?

A. I would agree that it would give it that additional

flexibility.
Q. Do you recall, Mr. Alderson-Smith, that during the discussions that took place in January, surrounding the subject of the termination of the voting trust upon loss of the Blue Cross/Blue Shield license, that Premera actually offered to remove the divestiture requirements while maintaining the governance restrictions and standstill provisions?
A. I believe that I actually was not present at that specific meeting in January.
Q. Had you been present, Mr. Alderson-Smith, would you have seen that as a reasonable approach to deal with this particular issue?
A. I would certainly see that as a move in the right direction. That would solve one of the issues with the maintenance of the -- of voting trust and divestiture agreement.
MR. MITCHELL: Nothing further. Thank you.

CROSS-EXAMINATION
BY MS. MCCULLOUGH:
Q. Hi, Mr. Alderson-Smith, I just have a couple of questions for you. As proposed in the Form A, Premera's veto power over the designated board member nominees means that Premera may never have to select one of these

nominees; is that right?
A. I suppose one could get into a situation -- although it is -- I mean, it sounds a little bit extreme -- where nominees are put forward, they are vetoed, more nominees are put forward, they are vetoed. So one could potentially get into a situation where no nominee's eventually adopted. I think that is a very unlikely situation -- but it is possible.
Q. But it is possible?
A. It is in the realms of possibility.
Q. There is nothing in the Form A that would require Premera to eventually select one of the nominees; is that right?
A. I think that is kind of an interesting situation. I mean, I don't think, from my personal point of view, that would be a situation that would play out. However -- however, there is no -- that they have gone after the 30th nominee they would really have to take somebody, or after a couple years -- there is a drop dead day or drop dead nominee they really have to take, to the best of my knowledge.
Q. Right. And it is my understanding that at the five-year mark neither of the Foundations will have this designated board member on Premera's Foundation; is that right?

A. As currently drafted, obviously you have heard that we may have a problem with that, but that is correct.
Q. Right. So then there is a potential that during that five years Premera may never choose a designated board member; is that right?
A. That's kind of an interesting way of looking at things, but I understand the point, and I would agree with you that technically this thing could be strung out for five years, which is an interesting point.
Q. And is it fair to say that having a designated board member sit on these various committees -- I believe, the executive committee, the pricing committee, and the compensation committees -- are important safeguards for the Foundations; is that right?
A. They are important safeguards for the Foundation.
Q. Okay. And Premera's board and these various committees won't be constrained from making any decisions in the absence of that board member being present; is that right?
A. Could you repeat the question, I am sorry.
Q. Sure. Premera's board and the executive committee, the pricing committee and the compensation committee, won't be constrained from making any of the decisions it would make if the designated board member was not selected?

A. No. That is my understanding of these documents.
Q. So -- and I think I just had two more questions. The unallocated shares escrow agreement I think Mr. Mitchell had suggested that the parties may freely amend that; is that right?
A. I think by -- so long as all the parties agreed, amendments can be made to that agreement, yes.
Q. And Premera is one of those parties?
A. That is right.
Q. So if Premera was not willing to amend this agreement, then the escrow agent would still be required to participate in the IPO; is that right?
A. If Premera was not willing to make the amendments, even though Alaska and Washington were?
Q. Right. For instance -- I am sorry, I didn't mean to interrupt you.
A. Could you just give me your for instance.
Q. Sure. For instance, if both of the Foundations asked Premera to allow them to be freed up to not participate in the IPO, but Premera didn't want that to happen, they would still be required to participate; is that right?
A. That is my understanding, yes.
MS. McCULLOUGH: Okay. Thank you. No further questions.

MS. DeLEON: I just have a couple questions.

REDIRECT EXAMINATION

BY MS. DeLEON:

Q. Regarding the ownership of Premera, as it is today, you said that Blackstone basically assumed that Premera was owned by the public; is that correct?

A. That is correct.

Q. In your review and due diligence, did you find any other entity or body or group that would own Premera?

A. We -- to the best of my knowledge, we did not find any other entity that may own Premera.

Q. And regarding the WellChoice transaction, did Blackstone set out to mirror -- or look at this to mirror the WellChoice transaction in every respect?

A. No. I think it is fair to say that WellChoice was an important benchmark, and it was perhaps -- among all the precedents -- perhaps the most important benchmark for some of the reasons I have testified to.

However, there are a number of areas where we believe this plan is different from WellChoice, more beneficial to the company, more beneficial to the Foundations.

So, clearly, that may have been a benchmark, but it clearly wasn't something that was slavishly adhered to in terms of the only standard which we wish to meet in every respect.

MS. DeLEON: Thank you. No further questions.

RECROSS EXAMINATION

BY MR. MITCHELL:

Q. Very brief redirect, Mr. Alderson-Smith. With Ms. McCullough's question about the selection of designated members, I have before me a copy of the voting trust agreement that addresses this. And the language in question says that Premera -- the board of Premera may veto nominees, only if they are not reasonably acceptable. Is that consistent with your recollection?

A. That is consistent with my recollection.

Q. And it continues that the board is obliged in those circumstances to promptly notify the beneficiary and the Alaska Health Foundation of its determination at the beneficiary's request to consult concerning the factors involved in such determination.

At that point, there will be jointly proposed one or more additional individuals from which the board of directors will choose. Is that consistent with your recollection?

A. That is consistent with my recollection.
Q. And are you aware of the provision of Washington law that requires parties to such a contract to act reasonably and in good faith?
A. I am not aware of that specific element, but I would absolutely take your word that that should be the case in contract law.
Q. Do you have any reason to believe that the board of directors of Premera would act in anything other than reasonable good faith in fulfilling its obligations under this provision?
A. I do not have any reason to believe that.
Q. You said in response to Ms. DeLeon's questioning that you did not find any group other than the public that might own Premera. Did you consider the possibility that, under Washington law, a non-profit corporation does not have any outside owners?
A. As one of the sort of qualifications I would like to make is that we did not -- I did not spend a lot of time looking for potential owners of Premera at this time. That was not something within my remit.
So I think it is fair to say that we didn't find any specific owners right now, nor did we find any lack of owners right now.
Q. You didn't really look at that issue, did you?

A. I really did not look at that issue.

MR. MITCHELL: Nothing further.

MS. McCULLOUGH: Just one question, Mr. Alderson-Smith.

RECROSS EXAMINATION

BY MS. MCCULLOUGH:

Q. Who determines which of the nominees are reasonably acceptable?

A. It is the Premera board who makes the determination as to whether the nominees from the Foundations are reasonable or not reasonable.

MS. MCCULLOUGH: Thank you.

MS. DeLEON: No further questions.

EXAMINATION

BY COMMISSIONER KREIDLER:

Q. Mr. Alderson-Smith, just a couple questions. One of them would be that -- is you have taken a look at the Amended Form A that is before us right now. Can you identify any particular or combination of factors that are more important for maintaining the value of the stock for the Foundations than others?

A. I would say that there are one or two elements that we have identified as being particularly important. And when we say value of the stock, not only do we mean just the sort of dollars and cents value per share for the Foundation, but also its value in terms of the extent of governance that we can bring to bear on the company and the flexibility in terms of the management of those shares, be that divestment or holding, etcetera.

I think that a couple of areas that are particularly important to us include a very clear identification of independence of the directors. I think that is a very important element that we discussed this morning.

And also the ability to make sure that the directors of the Washington Foundation actually wants on this board, subject to whatever the restrictions are, so that we can cut out citrus growth in Florida and other less-desirable potential groups of people.

But the fact that the Washington Foundation can have a director looking after its interests -- as well as looking after the interests of all the other shareholders -- that the Washington Foundation feels very comfortable with, trusts, knows is going to look after the interest of the Foundation. Those would probably be the -- perhaps the principal things just as I review the various elements that are of particular importance.

Q. The question on independence of board members, which you mentioned, are there limits as to the standards that could be imposed as a condition of approval of the Form A standards that you could require?

Obviously, the two percent, one million, has been talked about. Are there other factors that could be delineated --

A. I mean, obviously there are -- there are some other concepts. If, for example, the two percent and one million was to cut out the possibility, for example, of Premera going and bringing on board a new subscriber, clearly, that's something that none of us want to have happen.

Maybe there could be some additional drafting to ensure that these directors were still very clearly independent and were very clearly focused, -- specifically on Premera and all of the shareholders at Premera -- rather than on the special business arrangements with Premera. I think there could be a way to draft some additional language to maximize the clear independence of those directors -- and yet not harm Premera because clearly that is something we do not want to do.

Q. So there is a significant amount of flexibility that could be theoretically imposed as to standards for independence that could be applied, always with the understanding that you would not want to harm the corporation. But at the same time, could be there to enhance the issues that might be identified by the state of Washington or the Foundation of being paramount importance?

A. I would absolutely endorse that point. And clearly, just to make the point even more specific, it is obviously in the board of Premera's interest to do this. I have no hesitation that the board of Premera is also going to be highly sensitive to ensuring that in a best corporate government -- governance practices that are set out right from the beginning, right from the floatation of the company.

Q. Out of curiosity, out of the thousands of pages that -- and documents that have been submitted by Blackstone and others as a part of this overall review, have you ever received any comments from the Blue Cross/Blue Shield Association as to the standards that they have set in order to make sure the Blues mark is not lost by Premera?

A. I personally don't remember having any specific pieces of paper, that I have reviewed, that are specifically to do with that. I do know that there is a -- an overriding rule within the Blue Cross/Blue Shield Association that no non-institutional investor can hold more than five percent of a public Blue. But that excepted, I have not seen any specific documents to the best of my recollection.

Q. Relative to the Blues mark and the Blue Cross/Blue Shield standards -- and I believe there was a comment to the effect that the WellChoice standards were as far as they would go.

I think in history, have we not seen that the Blue Cross/Blue Shield Association has not always drawn a hard, firm line as to where its standards will be from one year to the next -- and I think specifically what happened when they made the change to allow for-profit companies to maintain the Blues mark. Is it true there is not a hard standard?

A. No. I think the only hard standard is the one I alluded to, namely, the five percent ownership capital, which appears to be quite hard, and I think a related 10 percent ownership cap for institutional investors.

But to the best of my knowledge, all of the other restrictions are not necessarily in some rule book that has been forever set out that you have to adhere to, I think there is some more flexibility.

Clearly, if you look over time, there has been some movement in the Blue Cross/Blue Shield Association. Clearly, it is difficult to predict how much more latitude there is, and obviously we sympathize and understand Premera's situation between an insurance commission and an association.

But, obviously, what we are trying to do is make sure we look after the best interests of the Foundations and the public in this procedure.

Q. Would there potentially be ways that the envelope could be pushed, so to speak, with the Blues Association --

A. It is --

Q. -- if there were issues that we found of importance, and at the same time not unduly jeopardize what I think is generally recognized as a valuable trademark?

A. It is a very interesting question. Obviously, as we sit here, not being parties to those discussions -- I mean, I almost sort of look out to Mr. Barlow and Mr. Marquardt and all the others, who actually have to go into battle with the Association and actually deal with these issues. As I sit here in my comfortable chair not having to do that -- and not, by the way, wishing to do that.

I fully understand that sitting here with my benefit of very little perspective and very little knowledge, not knowing any of the individuals on the other side of the table, I would suspect that there might be an opportunity -- there might be an opportunity to push the envelope a little further.

Having said that, we note that the envelope has already been pushed a little further in the meeting on the 20th of March, 2004. I think the boundaries were pushed a little. I don't know how much more those boundaries can be pushed. I am not sure they can be pushed anymore. That's really one for the company to figure out. It is a tough call, I have to say.

Q. Is there a safe way of playing that game without risking too much?

A. Without playing chicken, as Mr. Mitchell asked Mr. Koplovitz yesterday in the redirect? It is obviously one -- if there is a safe way to play that game, I am not sure that this is the right forum to even strategize on it, unless Mr. Mitchell wishes me to -- on his redirect, fill out my views.

Q. I can appreciate that. Let me ask a question that might be a little bit on the sensitive side, just because of the nature of Blackstone and its role in advising the state of Washington in this matter.

Would Blackstone be in a position to potentially benefit if in fact a conversion took place and a trust foundation was created because of consulting services that it might be able to participate in in the future?

And would that in any way be something that I should think about in judging Blackstone's advice?

A. Just in terms of how we are currently working, we are on a retainer right now with Premera -- pardon me, with you, with the OIC, but paid for by Premera. At some stage -- probably in the not too distant future -- that retainer arrangement will come to an end. We would then receive -- potentially receive certain fees if a further opinion -- either a fairness opinion or a procedures opinion -- is requested.

So there are certain fees -- in other words, if we go down a track now, there are certain fees that we may receive if the company was to go public, because you may require a procedures opinion or a final fairness opinion. So there is some financial bias for us if we go down that track.

We are certainly not anticipating that we would be the appropriate consultants to the Foundation. It is our view that the Foundation will probably require an investment bank who has significant capital markets expertise, who is able to sell the shares of the Foundation into -- into the markets and be a lead underwriter or a co-managing underwriter of the sales of those shares.

We at Blackstone are not able to do that, and therefore we would not anticipate that we would be involved or would be in any way compensated by the Foundation once that Foundation is set up.

But I would note that if we were to go down a path where you are generally positive on the conversion and you require opinions, those opinions would generate additional fees for us.

One interesting point, just for the sake of argument, in the Maryland conversion -- which, as Mr. Koplovitz testified yesterday was a, quote, "unsuccessful conversion," at least as far as the company was concerned it was unsuccessful -- we could have made an additional fairness opinion fee. Had the transaction gone ahead, we would have received a fairness opinion. However, in that situation, we came to the conclusion that that was not a fair transaction and the value was not being transferred. Therefore we forgo -- we did not receive that fairness opinion fee.

So hopefully that is at least some background on how we are compensated in any of biases that you may need to consider as you look at the testimony of myself and Mr. Koplovitz.

COMMISSIONER KREIDLER: Thank you for answering that question. It was one I felt an obligation to ask. Thank you, Mr. Alderson-Smith, I

have no further questions.
MS. DeLEON: I have no questions.
MR. MITCHELL: No, thank you.
MS. McCULLOUGH: No, thank you.
JUDGE FINKLE: Let's take a break.
(Morning recess.)
JUDGE FINKLE: Let's resume.
MR. HAMJE: Your Honor, Commissioner, the OIC staff calls Richard A. Ashley to the stand.

RICHARD A. ASHLEY, having been first duly sworn by the Judge, testified as follows:

DIRECT EXAMINATION

BY MR. HAMJE:
Q. Please state your name and business address.
A. My name is Richard Allen Ashley. My business address is 2001 Market Street, Philadelphia, Pennsylvania.
Q. Please describe your current position.
A. I am a tax partner with the firm of PricewaterhouseCoopers, LLP.
Q. Please describe your educational background.
A. I have undergraduate and graduate degrees in

accounting from Florida State University.

Q. Do you hold any licenses?

A. I am licensed as a Certified Public Accountant.

Q. Please describe your experience that is relevant to PricewaterhouseCoopers -- or PwC's -- engagement in this matter.

A. I will address my own experience. I have been involved in a variety of insurance company conversion transactions, including Blue Cross/Blue Shield Association transactions.

For example, I was involved in the conversion of Trigon, which is the Virginia Blue Cross and Blue shield plan. I was also involved in the proposed conversion of the Colorado plan.

I was also involved in the mutual holding company conversions of Pacific Mutual, as well as, Provident Mutual Life Insurance Company, and also the conversion of the Medical Inter-Insurance Exchange of New Jersey, and I have been involved in a variety of demutualization transactions, including MetLife, as well as Mutual of New York. I have worked on both the company side, as well as, the regulator side.

Q. What was PwC asked to do that resulted in your involvement in this matter?

A. PricewaterhouseCoopers was engaged by the Washington

OIC to advise them on a variety of matters. My particular involvement was with respect to the federal and state tax aspects of the proposed conversion.

Q. What did you do to fulfill your engagement?

A. We did a variety of things. First, we have reviewed a number of documents associated with the transaction. With respect to tax we looked at tax returns, tax work papers, we reviewed draft and final opinions by the advisors to Premera. We have reviewed the rulings from the state of Washington in a variety of transactional documents.

We met with Premera and its advisors and had a variety of different discussions with them. We also performed analysis of key issues and had a variety of discussions with the OIC and other advisors.

Q. In connection with PwC's engagement, did you participate in the preparation of one or more reports?

A. Yes, I did. I participated in the tax aspects of the PricewaterhouseCoopers reports.

Q. And does that include the accounting and tax evaluation?

A. It does.

Q. And the report on tax matters?

A. That's correct. The accounting and tax report was principally a due diligence report. I participated in the tax aspects of that. The tax reports addressed the basic issues that I will be addressing today, and there was also an addendum that dealt principally with Foundation tax matters, that will be addressed by Mr. Lundy that will testify after myself.

Q. Was there also an additional report that you were involved in preparing that was submitted in February of this year?

A. Yeah. There was an addendum to the report that addresses the progress we made recently with Premera in addressing and resolving several of the tax issues.

Q. Have you also submitted prefiled testimony in this matter?

A. Yes, I have. Prefiled, both direct testimony, as well as responsive testimony.

Q. Do you adopt your prefiled testimony and the portions of the reports in which you were involved in preparing?

A. Yes, I do.

MR. HAMJE: At this time the OIC staff offers Exhibit S-9, which is the accounting and tax evaluation of the proposed conversion of Premera Blue Cross of Washington by PwC. Exhibit S-11, which is a short biographical sketch of Mr. Ashley. Exhibit S-12, which is the report to the Washington State, Office of

Insurance Commissioner, on tax matters in connection with the proposed conversion of Premera. Exhibit S-13, which is the addendum to the report, to the Washington State, Office of Insurance Commissioner, on tax matters in connection with the proposed conversion of Premera. Exhibit S-40, which is the prefiled direct testimony of Mr. Ashley. And also Exhibit S-41, which is the prefiled responsive testimony of Mr. Ashley.

MR. MITCHELL: No objection.

MS. McCULLOUGH: No objection.

JUDGE FINKLE: Admitted.

Q. Mr. Ashley, please state the key tax issues that you analyzed with respect to the Premera conversion transaction.

A. There were principally four tax issues that we focused our attention. The first issue, which we view is by far the most significant tax issue associated with this transaction, is the matter of whether or not Premera will experience what we refer to as a material change in structure. Which, if they do experience such a material change in structure, they would lose significant tax benefits allowed to Blue Cross and Blue Shield organizations under federal tax law.

The second area we looked at was whether or not the transactions that comprise the conversion of Premera would qualify for tax-free treatment for federal income tax purposes.

The third issue was whether or not certain key tax attributes of Premera, principally federal net operating loss carryovers, as well as federal alternative minimum tax credit carryovers, would be subject to a limitation on their future use after the conversion transaction.

And finally, the fourth issue we looked at was whether or not there could be adverse state tax consequences from the conversion transaction.

Q. Mr. Ashley, you indicated that the material change issue -- the issues are the most significant -- or is the most significant tax issue.

Before you address it, would you please provide some brief comments on the significance of the other issues and the manner in which Premera addressed those issues.

A. I would be glad to. As I indicated in your question refers to the -- the material change issue is really the key issue I would like to talk about in my opening comments and questions and answers here. I would like to briefly comment on the other three areas, the first being the tax-free treatment of the conversion transaction itself.

As it has been indicated before in the testimony provided to this body, Premera intends to rely upon an opinion from the firm of Ernst & Young with respect to whether the transactions constitute tax-free transactions for federal income tax purposes.

I would like to note that we have been provided with that opinion, which is a short form opinion. However, that opinion is subject to the accuracy of assumptions and representations set forth in a technical memorandum in support of that short form opinion.

We have not been provided with a copy of that technical memorandum, and it is necessary for us to be provided with a copy of that technical memorandum and be given the opportunity to review that to determine whether or not the short form opinion is satisfactory to us. We have not been provided with that.

On the limitation of tax attributes, just, Commissioner, for your benefit and others, just a little bit of background on that. Whenever a corporation experiences a more than 50 percent change in its ownership over a three-year period, a limitation on tax attributes -- such as, net offering loss carryovers and certain tax credit carryovers, such as AMT credits -- can be subject to a limitation. It is an annual limitation imposed by the Internal Revenue code.

Premera has significant net operating loss carryovers and has significant alternative minimum tax credit carryovers.

Premera received an opinion from Ernst & Young addressing whether the conversion transaction itself would trigger this limitation on those tax attributes. E & Y provided an opinion that the conversion should not cause such a limitation. However, the opinion only addressed the consequences of the conversion transaction itself and not the effect of future changes in the ownership of Premera that could be caused by a sale of the stock by the Foundations, as well as additional sales of shares by Premera in IPOs or subsequent share offerings.

We have looked at information provided by Premera with respect to this issue. It does not appear to us that that issue would cause a significant adverse effect on Premera based on the information provided.

With respect to the state tax effects, I believe this was indicated in earlier testimony, Premera has received rulings from the state of Washington, which has ruled favorably that there should not be adverse state tax consequences to the transaction.

Q. Mr. Ashley, can you provide some background on the material change issue and specifically talk about what your concerns are with respect to that matter?

A. I would be glad to. I wanted to make sure that's working. Just by way of background, prior to 1987, most Blue Cross and Blue Shield organizations were tax exempt. They did not pay income taxes for federal income tax purposes.

As a result of the Tax Reform Act of 1986, Blues became subject to federal income tax beginning in 1987. However, in doing so, Blue Cross/Blue Shield organizations were provided with a series of benefits to cushion the blow, if you will, of going from tax exempt status to taxable status.

The four benefits that are provided are set forth in the slide here. The relevance and significance of those varies from organization to organization. In the case of Premera, the first issue, the special deduction, is the most significant, I believe. And the special deduction is a deduction that's allowed, again, to certain qualifying Blue Cross/Blue Shield organizations. It can be very significant -- it is very significant in the case of Premera. It substantially reduces the taxable income and the effected tax rate gets imposed on the organization.

The other three issues we have gone through with the company and advisors, and they do not appear to be of any real significance to the company.

In order to be eligible to receive the special benefits -- again, including the special deduction, which we believe is so significant to Premera -- the organization must not experience what's referred to as a material change in either its structure or its operations.

My concern is that the conversion transaction itself may well cause Premera to experience a material change in its structure, which again would cause the loss of these tax benefits I referred to.

Unfortunately, there is very little guidance as to whether or not the proposed conversion transaction itself will cause this material change. There is no statutory or judicial authority which sheds light on the meaning of a material change.

The legislative history with respect to this matter is very limited. However, I would like to note that the Internal Revenue Service has provided informal statements that they believe that a conversion transaction, such as the one proposed by Premera, will in fact result in a material change in structure, and that of course is always a concern.

Q. What has Premera done to obtain comfort with respect to this issue?

A. Premera has indicated to us that they intend to rely

upon an opinion from Ernst & Young with respect to this issue.
Q. Have you had a chance to look at this and review this tax opinion?
A. We were provided with a draft tax opinion -- a draft short form tax opinion -- which indicated that Ernst & Young believed that it was more likely than not -- and that's kind of a key phrase here -- more likely than not that the transaction would not cause Premera to experience a material change.
Q. Were you provided with a final tax opinion with respect to this subject?
A. No, we have not been.
Q. Please describe to the Commissioner and explain what a short form tax opinion is and what its significance is?
A. Yeah. I think it may have been mentioned earlier, Commissioner. This is all terminology in the tax world that has developed over the years, you may or may not be familiar with it.
A short form opinion is an opinion that provides an opinion of the advisor, but it does not provide a well-reasoned analysis of how they reached their opinion.
Q. What's the significance of a more likely than not

opinion?
A. A more likely than not opinion is exactly what it says. It is more likely than not that that is the outcome. It is more than 50 percent. And in the tax world, a more likely than not opinion is typically not a real strong level of opinion. For a significant issue, most companies would prefer something above that if they could achieve it. But it is just what it says, it is more likely than not, at least in my view.
Q. Given this level of opinion, in your analysis, what does this mean with respect to the degree of risk associated with this issue?
A. I believe there is a considerable degree of risk associated with this issue.
Q. If Premera were determined to experience a material change in structure, what would be the likely result?
A. Based on the conversations in the analysis we have performed, again, the key is this special deduction that is the most significant to Premera. If they were to lose the special deduction as a result of a material change, based on the information we have obtained from the company, we do not believe there would be any immediate cash flow adverse effects. Although there certainly would be over time -- not immediately, but over time. However, there would be, I believe,

significant and dramatic financial statement implications that would be caused by a material change.
Q. Could you describe the financial statement impact.
A. I would be glad to. The bottom line, the key is, on a perspective basis, if Premera would experience a material change and lose the favorable Blue Cross and Blue Shield benefits, including the special deduction, that special deduction provides a current benefit. It is referred to in the accounting terminology as a permanent benefit, and it reduces the effective tax rate that's imposed on its earnings, generally by about 15 percent.
So if the special deduction was lost, Premera's tax rate would go up generally by about 15 percent, and its bottom line would go down by 15 percent. A 15 percent effect on the bottom line I think in most people's judgment is a significant issue.
Q. Could you just please summarize what you believe are the most significant tax issues that the Commissioner should consider when deciding whether to approve the proposed transaction?
A. Just cutting through it, just to summarize my thoughts for just a moment, I think the real key issues here are this material change issue, which could result in Premera losing the special Blue Cross and Blue Shield

benefits, having an adverse effect on its effective tax rate going forward.

And I am not an investment banker, but one would think that the strain on earnings could cause a diminution in the value of the enterprise.

And, again, we would like to be provided with this technical memorandum in support of the short form opinion on the tax-free nature of the transactions so we can complete our review.

MR. HAMJE: That's all the questions I have at this time.

MR. MITCHELL: May I approach the witness, Your Honor?

JUDGE FINKLE: Yes. Did you have another copy or --

MR. MITCHELL: Yes.

CROSS-EXAMINATION

BY MR. MITCHELL:

Q. Mr. Ashley, your wish is our command. I actually did not intend for this to be a dramatic moment, but we just received this this morning, and I am happy to provide to you the technical memorandum in support of the Ernst & Young short form opinion, which you doubtlessly will review at your leisure, and I would not

ask you to do so now.
A. I hope not. It is pretty long. It is 117 pages.
Q. Maybe that's why it took them so long to get it to us, I don't know. As compared with your original report, Mr. Ashley, your supplemental report reflects tremendous progress by Premera in addressing the concerns that you had identified initially, is that not true?
A. Yes, we did make progress.
Q. And with respect to the tax-free nature of the proposed reorganization, is it not the case that it was reasonable for Premera to rely upon the opinion received from Ernst & Young?
A. We do not find it to be unreasonable to rely on such an opinion.
Q. Now, you say that the potential loss of the special deduction -- which I gather the lingo is 833(b) deduction -- is the most significant tax issue; is that right?
A. I believe so. Certainly, if the transaction was to not be tax-free, if it was a taxable transaction, there could also be significant tax implications on the transaction, but there is a strong level of opinion offered by E & Y.
Q. So I think you would agree with me, would you not,

Mr. Ashley, that 833(b) issue is the most significant here, because it is the only one that's not -- at this point -- resolved, or as close to resolved as we can resolve it?

A. I think that's true.

Q. Now, with respect to the potential loss of the 833(b) deduction, Mr. Ashley, would you not agree that this is a very unsettled area of tax law?

A. Yes. As I indicated before, there is scant authority with respect to the issue, and it is clearly an unsettled area.

Q. Would you also agree with me, Mr. Ashley, that Premera has reasonable arguments to support its position that it should be able to retain the deduction, special deduction?

A. Yeah. I think it has some substantial arguments to support a position that the 833(b) deduction should be maintained and the company will not experience a material change, but I believe there is a significant risk that they may not prevail on that issue.

Q. And with respect to that last point, Mr. Ashley, would you not agree with me that the outcome of this question will not be known for many years?

A. A good chance of that.

Q. Because the way in which the issue might come up is

on audit, in subsequent years. The IRS, if it takes a position on audit, consistent with the informal position that you indicated in your testimony, would lead to a potential dispute that would only be resolved in tax court or US District Court; is that right?
A. Yeah, that's certainly one scenario, and that could occur for Premera, or it could apply for another Blue Cross/Blue Shield organization who may be challenged on that issue.
The service may also issue other authorities with respect to the issues, such as a revenue ruling, that would provide a stronger level of view of service.
Q. The informal position to which you alluded has no force of law; is that right?
A. I think that's probably a correct statement.
Q. Would you also agree with me, Mr. Ashley, that if the deduction is lost, the impact on Premera's bottom line will be deferred because of the existence of tax attributes, such as net operating loss carryovers?
A. No, I do not think I agree with that.
Q. Apart from the financial statement impact, would you agree with that?
A. I think the financial statement impact is very significant here.
Q. With respect to this special deduction, it is a

deduction that, by its terms, is not meant to last forever; is that not true?
A. I am not sure what you mean by that.
Q. The ability of a Blue Cross/Blue Shield Association to claim this deduction disappears over time, does it not?
A. Well, companies can work their way out of the deduction, if you will. Perhaps that's what you are referring to. The deduction is equal to 25 percent of claim and claims adjustment expenses over adjusted surplus.
As a company grows and it accumulates an amount of surplus, quite often the deduction is diminished over time, but there is nothing that causes the company, under current law, to not be entitled to the deduction. It is a question of the mechanics.
And based on -- just to elaborate on that point -- based on the projections provided by Premera, I believe the company believes they are going to receive substantial benefits for this deduction for many, many years.
Q. Would you agree with this point, Mr. Ashley, that the risk of losing the 833(b) deduction is unavoidable if there is to be any transaction that puts substantial value into the Washington Foundation?

A. If that's done through a conversion of the company from a non-profit/non-stock, to a for-profit/stock company, which is what is proposed in this transaction, I think the risk will arise.

I just believe it is important for the Commissioner and other interested parties to be aware that the conversion transaction has with it this tax risk, and therefore potential -- imposition of additional taxes on the organization, and therefore diminution of the value of the organization. That's the important point I would like to make here. I agree with your general statement.

MR. MITCHELL: Nothing further.

CROSS-EXAMINATION

BY MS. McCULLOUGH:

Q. Is there something called an IRS private letter ruling?

A. An IRS private letter ruling is a means by which a company can request an opinion or advice from the Internal Revenue Service on the tax consequences of a particular matter.

Q. So is it possible then that Premera could have stocked this private letter ruling from the IRS to clear up whether or not this conversion would result in a loss of the 833(b) benefits?

A. That is possible. They could have gone to the Internal Revenue Service. Whether or not the Internal Revenue Service would have ruled on that issue is not clear. They have not, to date, ruled on that issue.

MS. McCULLOUGH: Thank you.

MR. HAMJE: No questions.

EXAMINATION

BY COMMISSIONER KREIDLER:

Q. I am curious right now as to how some of the other plans that have gone through conversion, what their experience was relative to these tax benefits. Have they been harmed in this process or lost their 833(b) tax benefit or not?

A. That's an excellent question, Commissioner. Let me answer it in a couple of ways. The significance of the material change varies from Blue to Blue, if you will. In some of the prior transactions, that issue wasn't as significant as it is to Premera. A lot of the companies had surplus levels where the special deduction was very small or they were not entitled to special deductions and the other items weren't that significant. So many other conversions, this material change issue, wasn't as big of a deal as it is I think in the Premera transaction.

Also, I will note that in several of the prior conversions, at least for financial reporting purposes, the plan took the position for financial reporting purposes that it did experience a material change and reported its financial affairs on that conservative basis.

It is our understanding that Premera intends, subject to further review and consideration, to report its financial affairs on the basis that it does not experience a material change.

Q. So the point that you would make, Mr. Ashley, would be that potentially this conversion could experience more harm than any of the substantive conversions that have taken place in the past?

A. Yeah. The ones I have been involved with that I can think of is not as big an issue as it is here, yeah.

COMMISSIONER KREIDLER: Thank you, very much.

MR. HAMJE: No follow-up.

RECROSS EXAMINATION

BY MR. MITCHELL:

Q. I have I couple of questions of follow-up, Mr. Ashley. First, with respect to Premera's plan with respect to this issue, is it your understanding that

Premera will disclose the issue in its Form S-1 as a footnote?
A. I think so. We had discussions about that, and it was not clear in our discussions exactly what or the manner of how it would be disclosed. I would think it would need to be disclosed and I think it has been in -- I can think of Mr. Mitchell in the Trigon transaction and the WellChoice, that there were disclosures in both of those, I would think it would need to be here.
Q. In the WellChoice precedent, Mr. Ashley, would you confirm my understanding that the converted entity took a position from a financial reporting purposes, a GAAP position, that assumed the loss of the 833(b) deduction, but that WellChoice continued to claim the deduction on its tax return?
A. That's my understanding.
Q. And in the circumstances described there, what, if any, impact was there upon the value realized by the Foundations upon the sale of Blues stock?
A. I am not in a position to answer that. You would have to ask an investment banking person or another competent person in that area. That's not an area I can make a judgment on.
Q. Would you agree with me, Mr. Ashley, that the WellChoice transaction was a very successful conversion,

certainly from the standpoint of the Foundation?
A. I am not that familiar with the transaction and probably shouldn't comment on that.
Q. Finally, am I correct in my understanding, Mr. Ashley, that PwC assumed that the Section 833(b) deduction would be lost?
A. Yeah, I think that's a good point. We originally had requested that this transaction be conditioned upon the receipt of an acceptable opinion with respect to this matter, and it was suggested by Premera that it not be. And we thought that was not an unreasonable position, because we thought there was a reasonable degree of risk associated with it.
And in doing so, we suggested that the advisors do their analysis on the assumption that the material change would occur, the tax benefits would be lost, to look at it on kind of a worst case basis, and our firm took that approach, and I believe some of the other advisors did as well, including the investment bankers.
MR. MITCHELL: Nothing further.
MS. McCULLOUGH: Nothing.

EXAMINATION
BY COMMISSIONER KREIDLER:
Q. Mr. Ashley, I am curious. It seems like there is

such a void here. I can understand the reservations about not always wanting to go to the IRS and ask a question, but it seems like there is precedent that had to have been established by rulings, by the IRS on 833(b) deduction and that issue.

Is it your -- to your knowledge, are there no rulings that have taken place that are on point enough so we have some real substantive ground here to grab hold of?

A. Unfortunately, that's the case. The areas that they have ruled on, Commissioner, have not been on point with respect to our issue. They have not ruled on a conversion of a non-profit/non-stock to a for-profit/stock company. They have not ruled on that.

They have issued guidance, and the committee reports provide some guidance on a split-up or merger of two Blues where there is no substantive change in the structure of the organization. They provided guidance, going from a non-profit to a mutual organization, is that a material change, but nothing on point that addresses our situation, unfortunately.

Q. Thank you, very much.

A. So we are kind of looking in the crystal ball, if you will, and that's why there is a reasonable degree of risk.

JUDGE FINKLE: Any follow-up?
MR. HAMJE: None from the OIC staff.
MR. MITCHELL: None.
JUDGE FINKLE: Thank you. Please step down.
MR. HAMJE: May this witness be excused?
MS. DeLEON: Your Honor, the OIC staff would like to call Joseph Lundy to the stand. Mr. Lundy is setting up his computer, he will be a minute.

JOSEPH LUNDY, having been first duly sworn by the Judge, testified as follows:

DIRECT EXAMINATION

BY MS. DeLEON:
Q. Please state your name for the record.
A. Joseph Edward Lundy.
Q. Where do you currently work?
A. I work at PricewaterhouseCoopers, 2001 Market Street, Philadelphia, Pennsylvania, where I am a consultant to the firm.
Q. Could you please briefly describe your educational background.
A. I received my Bachelor of Science in economics at the Wharton School of the University of Pennsylvania. I

received a Juris Doctor at Temple University, School of Law, and a Master in legal letters, in the field of taxation, at New York University, School of Law.
Q. Could you briefly describe your work experience.
A. I have been a practitioner of law for 28 years and the last seven years have been a consultant for the firm of PricewaterhouseCoopers.
I am a former chair of the American Bar Association, Tax Sections and Exempt Organization Committee. I am a Co-editor in Chief of the journal known as the Journal of Exempts, published by Warren, Gorman, Lamont.
I am an adjunct faculty member of the Temple University, School of Law, where I teach -- and have taught -- for 30 years a course in the exempt organization law.
Q. Could you please describe your experience regarding the federal tax aspects of forming and maintaining non-profit tax exempt organizations.
A. Over the course of my career, I have devoted more than half of my time to the matters involving the formation and maintenance of tax exempt organizations. And, in the last 15 years, my exclusive time has been devoted in that area.
In particular, with regard to conversions of Blues organizations, I was involved in the Colorado

conversion.
I have also formed, personally, many tax exempt organizations, and converted many tax exempt organizations for-profit, as well as assisting them to go from for-profit to tax exempt status.
Q. Did you prepare a prefiled direct testimony for this proceeding?
A. I did.
Q. Did you also assist in the preparation and submission of Exhibit 1 to PricewaterhouseCoopers' report on tax matters, dated October 27th, 2003?
A. Yes.
Q. Did you also assist in the preparation and submission of Exhibit 1, to the report addendum on tax matters, in connection with the Washington Foundation Shareholder and the Alaska Foundation, dated February 27th, 2004?
A. Yes. I did.
Q. Did you also prepare a report on allocation tax matters dated March 29th, 2004?
A. Yes.
Q. Are these reports incorporated by reference in your prefiled direct testimony?
A. Yes.
Q. Did you also attach a curriculum vitae to your

prefiled direct testimony?
A. I did.
Q. Mr. Lundy, do you adopt all of your prefiled direct testimony in this matter?
A. I do.
MS. DeLEON: Your Honor, with Mr. Lundy's adoption of his testimony that's been previously filed and served in this matter, we would move for admission of Exhibits S-14, S-15 and S-55.
MR. MITCHELL: No objection.
MS. HAMBURGER: No objection.
JUDGE FINKLE: Admitted.
Q. Mr. Lundy, could you please briefly summarize your opinions regarding the federal tax aspects of the part of the proposed conversion transaction involving the formation and operation of the proposed Washington Foundation?
A. In summary -- and for reasons that I will explain and elaborate on in a little bit of detail -- I think it important and in the interest of the public that the Washington Foundation qualified for federal tax exemption.
I also believe that the Single-Tier Social Welfare Organization Model that has been proposed in the Amended Form A is more tax efficient than any other feasible

model.

I think that the Single-Tier Social Welfare Organization Model appears to be a model that is otherwise effective, efficient, practical, and in the best interest of the public.

That is, I think it strikes a reasonable balance among at least three competing concerns, those concerns being tax efficiency, simplicity, and inspiring public confidence.

The Single-Tier Social Welfare Organization Model, I believe, is achievable. I do have some concerns about the Internal Revenue Service's willingness, as the documents are currently formulated to immediately recognize it, but I do believe that this model is achievable.

Lastly, and in summary, in order to eliminate any uncertainty and potentially have impacted considerable tax liabilities, I believe that the closing of the proposed conversion should be conditioned upon obtaining recognition that the Washington Foundation is a social welfare organization.

Q. Why is it important and in the best interest of the public that the proposed Washington Foundation be determined to be exempt from federal income tax?

A. As the slide that is currently going up on the overhead indicates, recognition of federal tax exemption, on the part of the Washington Foundation, will eliminate certain potential tax liabilities.

Judge Learned early on said in one of his more significant opinions, "It is perfectly proper to so structure your affairs to avoid taxation. What is not proper is to structure one's affairs to evade taxes."

In this instance, properly recognizing the Foundation as a tax-exempt, social welfare organization, will eliminate the following potential tax liabilities.

Federal income tax might well be imposed upon the receipt of the Foundation of the shares of new Premera at a rate of close to 35 percent, 35 percent of the fair market value of those shares upon receipt, unless the Foundation is determined to be tax exempt.

Second, even should there be a determination -- and there is a basis to conclude that the receipt alone may not be a time to tax the Foundation -- upon subsequent sale of those shares, as an IPO or otherwise, there will be a tax liability imposed on the gain, recognized upon that disposition, and to the extent that there had not been a tax imposed at the time of the receipt, and the basis of those shares was little or nothing in the hands of the Foundation, the tax liability again would be a little bit less than 35 percent of the total amount of the proceeds received upon the sale.

Last, any income derived from the proceeds of the sale in the form of dividends, interest, royalties, rents, or other forms of income -- including gains upon subsequent dispositions of investments -- would be subject to federal income tax at rates that might be approaching in the area of, again, 34 percent.

In order to eliminate the possibility of those types of taxes, which could be literally in the hundreds of millions of dollars, it is important, in my point of view, for the public's interest and everybody else's interest in the transactions that those taxes not be triggered.

Q. In the context of the role of the proposed Washington Foundation, could you please summarize the difference between being classified as a social welfare organization as opposed to a charitable foundation?

A. Slide number four, please. There are more than 30 different types of tax exempt organizations. The two that are most appropriately considered in the context of the Washington Foundation are either a charitable organization or a so-called social welfare organization.

A charitable organization is distinguishable from a social welfare organization. If you would, please, put up slide number eight. In the sense that in each case a charitable organization and a social welfare organization are organized and operated so as to not have any private gain, each is exempt from federal income tax as a general rule, but subject to tax nonetheless on its so-called unrelated business income.

The core underpinning similarity and distinction between a charitable organization and a social welfare organization deals with its mission. A social welfare mission is incorporated and encapsuled in the concept of charity, but not the reverse. That is, a charity can include a social welfare organization, but a social welfare organization cannot include a charity.

Q. How does an organization, like the proposed Washington Foundation, obtain a formal IRS determination that it is exempt from federal income tax by reason of being a social welfare organization?

A. In order to achieve certainty that a social welfare organization is entitled to federal tax exemption, there is a formal Internal Revenue Service procedure, which requires the filing of a lengthy application, in which certain information is provided to the Internal Revenue Service, basically providing to the service an opportunity to make a reason judgment as to whether that organization satisfies the critical elements constituting the definition of a social welfare organization.

That process is triggered by the filing of an application, along with certain other documents, and the paying of -- humorously enough -- a user fee, a payment -- another fee, Commissioner, that comes out of the pocket of somebody, and in this case to the tune of $500.

Q. Is there currently a determination by the IRS of the Foundations' tax status?

A. To my knowledge, there is no determination that has been received. Although I believe from listening to prior testimony over the last few days, that there may have been a process begun in which the application may or may not have been filed. I do not know.

Q. Does that concern you?

A. It does not concern me that there has been a process initiated, to the contrary, since the timeline for obtaining this process is very uncertain. The Internal Revenue Service receives as many as 80,000 of these applications for tax exemption a year. The process by which they handle those applications is very, very difficult, to say the least. They are very, very constrained with resources, and it is very difficult -- if at all possible -- to predict how quickly such applications will be examined and determinations made.

There are expedited procedure processes, which hopefully could be brought into play in this instance.
Q. If the proposed Washington Foundation is determined by the IRS to be a social welfare organization, will it be required to file federal income tax returns?
A. Yes. A social welfare organization does file a federal information return, it is not a tax return. It is IRS form 990, and it requires certain information, much of the same type of information that is required of a charitable tax exempt organization.
Q. How else might the Foundation be regulated or affected by the IRS or by federal tax law?
A. As an organization that has been recognized as exempt by reason of being a social welfare organization, the Internal Revenue Service is charged with the responsibility of monitoring from time to time its compliance with those requirements.
And it is not uncommon for organizations of this nature to be examined in the same fashion that charitable tax exempt organizations are examined to determine whether they are in compliance with the requirements for their continuing exemption.
Q. Are there any other thoughts or concerns that you wish to express regarding the potential federal tax implications of forming and maintaining a proposed

Washington Foundation as a tax-exempt, social welfare organization?

A. The only other area that I have seen that has given me any pause is the most recent Unallocated Shares Escrow Agreement, the USEA. As my last report indicates, it creates some additional tax concerns, without regard to whether the ultimate organization is recognized as a charitable exempt organization or as a social welfare organization.

The reason for that is that the transactions that might occur while those shares are in the escrow agreement, and the gain and income that might be derived from those shares, it is problematic as to whether there could be taxation imposed on that income and those activities. While I do not believe that it should, I believe that it is an uncertainty.

Q. Do you have any other concerns that have not been addressed?

A. I do not.

MS. DeLEON: Thank you. No further questions.

CROSS-EXAMINATION

BY MR. MITCHELL:

Q. Good morning, Mr. Lundy.

A. Good morning, Mr. Mitchell.
Q. You are, as I understand it, a tax professional with a particular focus on non-profit, tax-exempt organizations; is that correct?
A. That is correct.
Q. And Premera, Premera Blue Cross are not such organizations, are they?
A. They are not.
Q. Your reports and your testimony today focus upon the structure of the Foundations that will be established to receive Premera's initial stock, to monetize that stock, and then distribute the proceeds to address unmet health needs; is that right?
A. That is correct.
Q. And the Foundations that are proposed to be established are designed to be both non-profit and tax exempt; is that right?
A. That's correct.
Q. From a tax-planning standpoint, Mr. Lundy, would you agree that the transaction documents in Premera's Amended Form A are designed to minimize the taxes and operational rigidities that would flow from an alternative structure?
A. Yes, I do.
Q. Would you agree, as well, that from a tax-planning

standpoint, those transaction documents appear likely to achieve their objective?
A. Yes, I do.
Q. As part of your analysis then, Mr. Lundy, did you review conversion transactions that had taken place in other states?
A. I did.
Q. And you are aware from that review, are you not, that in recent years state attorneys general and insurance commissioners had been exercising more stringent regulatory review of proposed conversions?
A. I am so aware.
Q. In some cases, is it not the case that state attorneys general have filed lawsuits to set aside the full value of conversion proceeds to charitable use?
A. That is my understanding.
Q. In our case here, Mr. Lundy, is it not the case that the goal of such a claim by a state attorney general, namely, to set aside the full value of the conversion proceeds for charitable use, has already been accomplished by Premera's proposal?
A. I believe it has.
Q. Last week Commissioner Kreidler heard testimony from Lewis Reid, who described himself as a tax geek. Are you familiar with Mr. Reid's expert reports?

A. I have reviewed them and I agree with Mr. Reid -- although I wouldn't say geek, but certainly an accomplished tax professional.

Q. I think the world would be a better place if accomplished tax professionals were in charge, at least insofar as this transaction is concerned, because you and Mr. Reid basically agree with each other, do you not?

A. I think that is correct. We have slight differences on the achievable of the Social Welfare Organization Model. But otherwise, I do not think we have any disagreement on the desirability of the outcome.

Q. For example, Mr. Reid, in his prefiled responsive testimony, which is Exhibit P-12, at page 12, endorses the proposal that you have offered in your most recent report, which is Exhibit S-15, for the Foundation's report income arising from funds or shares that are escrowed in the USEA, the Unallocated Escrow Agreement; is that right?

A. That is right.

Q. And I assume you would agree with Mr. Reid that the most straightforward solution to any issues associated with the USEA, would be for the states to agree upon an allocation of the shares, which would render the USEA superfluous; is that right?

A. That is correct.

Q. Do you agree with Mr. Reid that Premera's proposed conversion is designed to deliver the greatest dollars to the charitable organizations that will be established as a result of the conversion?

A. I don't have the expertise, Mr. Mitchell, to opine in that regard.

Q. Mr. Reid has observed that given the practice of philanthropic organizations to pursue programs that leverage their assets for greater social good, the Foundation's impact and influence in this case could well be much greater than the size of their endowments. Do you agree with that?

A. Yes, conditionally, Mr. Mitchell. One of the areas that I did examine in the process of my review are the series of documents that go through the task of forming the Foundation, the proposed articles. And then additionally and critically as well, the so-called transfer grant and loan agreement.

The reason I say conditionally, is that in the articles of incorporation, there starts with a purpose clause which explains -- very, very well, I believe, from everybody's perspective -- the proposed purposes for the Washington Foundation.

The powers then that follow a separate article of those -- articles of incorporation, limit the powers of the organization when formed to directly following or pursuing -- the purposes set forth in the purpose clause -- pursuing the health needs of the citizens, the residents of the state of Washington. As well as indirectly -- as well as indirectly fulfilling those purposes by way of making grants exclusively to charitable 501(c)(3) organizations.

The document then that is described as the grant -- transfer grant and loan document, further restricts the power of the Foundation -- not the purpose, but the power of the Foundation -- to -- I believe, the language of the document is solely use the proceeds from the sale of the new Premera stock for grants to charitable 501(c)(3) organizations. In that context, the leverage may be diluted.

Q. But still possible though; is that right?

A. Yes.

Q. Mr. Reid has stated, and I quote, "The Conversion Transactions serves the public interest by permitting Premera to continue as a vital company with assets to the capital markets, while unlocking the charitable potential in its assets by adding two new large sources of philanthropic health funding in the states of Washington and Alaska," closed quote. You agree with

that, do you not?
A. I do. I do.
MR. MITCHELL: Nothing further. Thank you.

CROSS-EXAMINATION

BY MS. HAMBURGER:
Q. Good morning.
A. Good morning.
Q. I just had a few questions. Your testimony earlier this morning about the federal tax status, when you referred to charitable and social welfare organizations, you were referring to federal law that designates charitable and social welfare organizations; is that right?
A. That is correct. And being in that tribe of tax geeks, I was trying to avoid the IRS terminology, 501(c)(3) versus 501(c)(4).
Q. So you weren't having any opinion on those terms charity or social welfare in the context of Washington State law?
A. I had no focus on that terminology as it is used under Washington law.
Q. Now, some Foundation -- you testified that you have studied the conversion entity, Foundations formed from conversions in other states?

A. That is correct.
Q. Some of those conversion entities have been established as 501(c)(4) organizations?
A. That is correct.
Q. And some have been -- had included similar restrictions that 501(c)(3) organizations have in their articles of incorporation and bylaws?
A. That is correct.
Q. Including a minimum five percent annual grant making?
A. That is correct as well.
MS. HAMBURGER: Thank you.
MS. DeLEON: I have no questions.
MR. MITCHELL: One follow-up question, Mr. Lundy.

RECROSS EXAMINATION

BY MR. MITCHELL:
Q. You had observed, I think in the overview slide, that you recommended that a consideration of the condition upon the Commissioner's approval of the proposed conversion that would be focused upon receipt of recognition of tax exempt status of the Foundation; is that right?
A. That is correct, Mr. Mitchell.

Q. Am I correct in my understanding that your recommended condition would focus on tax exempt status, not specifically on (c)(4) versus (c)(3) status?

A. I think that is a correct statement, Mr. Mitchell. The current document identified as the plan of conversion would -- at Article 4, as I recall -- condition the closing of the conversion transaction upon the receipt of a -- of recognition or the filing of an application. What concerned me was the -- were the filing of the application and not having the actual receipt of the recognition of exemption.

I believe that, were it ultimately determined to be a 501(c)(3) organization, as opposed to a 501(c)(4) organization -- that is, a charity as opposed to a social welfare organization -- that there would not be quite the same tax efficiency, but that the significant potential tax implications would be eliminated.

By that, I was hoping to avoid any explanation, but I will just make a very brief one. And that is, that in the event that the Foundation is classified as a charity for federal tax purposes, it will -- in all likelihood, if not certainly -- also be categorized as a private foundation. And as a private foundation, it will be subject to -- among other things -- a two percent excise tax -- not an income tax, an excise tax -- on, among other things, the gain derived from the monetization of the new Premera stock.

In the event that it is categorized as a social welfare organization, there would not be such a tax liability imposed. Therefore, most tax efficient, social welfare organization. Next, charitable tax exempt organization.

Were it to become a charitable private foundation, in addition to the two percent excise tax that would be imposed on the gain derived from the sale of the new Premera shares -- which would be virtually the entire amount of the proceeds -- there would also be a similar tax imposed on any investment income, including subsequent gains upon the sales of other investment vehicles that the Foundation would invest in from time to time.

And there would also be a series of IRS-imposed restrictions on the use of the funds, how much money would need to be distributed annually, and other limitations on the trustees of the Foundation in order to maintain tax status.

Q. Bottom line, your proposed condition is receipt of recognition of tax exempt status, either as a C3 or (c)(4)?

A. Yes.

MR. MITCHELL: Thank you. Nothing further.
MS. DeLEON: Nothing further.
MS. HAMBURGER: Nothing.

EXAMINATION

BY COMMISSIONER KREIDLER:

Q. I just have a couple of questions here. One is that in the event that the IRS either ruled that the Foundation was subject to a 34 percent or a two percent, are there tax consequences -- are there other structures or amendments or alternatives that would be available in order to avoid the interpretation of the IRS?

A. I believe that it is highly unlikely that the Internal Revenue Service will not rule favorably that the Foundation is either a charitable exempt organization or a social welfare organization.

In the unlikely event that it were to rule unfavorably in either of those categories, the only other category which I believe could possibly be applicable, but which I understand has more challenges and difficulties -- would be to have the Foundation categorized as an instrumentality of the state.

Q. Interesting. Thank you. Of the Insurance Commissioner's Office?

A. No comment.

Q. In reviewing the analysis that was done by Mr. Reid, how would you judge your level of confidence in the IRS ruling favorably, from yours to Mr. Reid's, as the same? Or are you less optimistic or more optimistic than Mr. Reid?

A. I think we are about the same. I believe that it is very possible that the Internal Revenue Service will, as a condition of approving recognition, request modifications of some of the documentation. Exactly what will be requested, I cannot speculate. It is a process that is very, very -- lacks uniformity. Lacks uniformity.

As one of the counsel for the Intervenors asked me the question about other conversion transactions and elements that were in those transactions, which were approved by the Internal Revenue Service, when you have seen one conversion transaction, you have seen one conversion transaction.

COMMISSIONER KREIDLER: Thank you very much, Mr. Reid. That's all I have.

MS. DeLEON: No questions.

JUDGE FINKLE: See you at 1:30.

(Lunch recess.)

THE COURT: Ready to proceed?

MR. KELLY: Yes. I do have a preliminary

motion.

THE COURT: Can I interrupt you with something preliminary of my own?

MR. KELLY: Sure.

THE COURT: There is a letter dated May 10, directed to Commissioner Kreidler, from Gloria Glover, who is the Chief Financial Examiner for the Alaska Department of Community and Economic Development, indicating that in the 24th order in this case the Commissioner invited the Alaska Director of Insurance to call one of her staff to inform you -- that is the Commissioner -- to a written statement of any information which the ADI believes should be aware of in connection with the proposed conversion.

They have provided such a comment by report captioned, "Statement of Alaska Division of Insurance Regarding Proposed Conversion of Premera," that is attached to the letter I just referred to. This was received by the Commissioner just now, by his office, just late this morning as I understand it.

The report will be made available to all parties, and we will see what is to be made of it. But I just wanted to announce that to you and it will be made available. The report appears to deal strictly with the allocation issue, although I truly have only had a couple of minutes to look at it. So the staff will make it available to you. Go ahead, Mr. Kelly.

MR. KELLY: Yes. I have a motion to exclude PowerPoint slide presentations that have just been given to us by the OIC staff. I base the motion upon the Court's and Special Master's order, that all such illustrative exhibits were supposed to have been produced by April 26th.

You will recall that we have done this in our case, of course we are finished and there is a different approach for this.

This morning, while I was out preparing for Mr. Nemerov, I understand we were handed a 17-page PowerPoint slide presentation from Mr. Nemerov, which I barely had a chance to look at.

This afternoon, I came in and I was asked if I was going to be getting to Ms. Hunt this afternoon. When I said yes, as the magic word, I then got a 28-page PowerPoint slide from Ms. Hunt. I submit that if I had said no, I would not get to her this afternoon, I would have gotten this tomorrow morning.

Once I made that statement it was apparent what needed to be done, so then I got Mr. Staehlin's 34-page PowerPoint slide. I hope this isn't a geometric progression.

This is wrong. It isn't fair to us, it is in violation of your order, and it is just simply a sandbag. And I ask that the proper remedy is to make these folks just talk without their PowerPoint slides.

They could have presented these at any time, certainly by the deadline, and they chose to wait -- not only beyond the deadline, but until literally the last possible moment each time.

MR. HAMJE: All that I can speak to with respect to these presentations is that they are simply summaries of the testimony that will be given by these witnesses.

It is my understanding these are not going to be introduced as exhibits, are not going to be given to the Commissioner to review as part of the record, but only there for the purpose of following along with the testimony, as have been done with several of Premera's witnesses as we have seen.

We have -- these particular exhibits that were presented -- items that were presented to Mr. Kelly this afternoon, only were prepared over the lunch hour. We only just received them and were able to get them together. To be perfectly candid, we did not anticipate that this morning would go quite as quickly as it did. And so we have been trying to get these things all put together as quickly as possible to get them to the other parties.

And the first one we delivered was earlier this morning, as soon as we could, after it had been prepared, and then these next two during the lunch hour, when they were completed.

We would ask that the motion be denied, because this would be very useful to the Commissioner and other members of the public and the staff to be able to follow along with the presentations made by these witnesses.

THE COURT: Could you remind me of the language of the order that you are referring to?

MR. KELLY: I will turn to my colleague.

MS. HAMBURGER: Your Honor, while they are looking that up, I would like to make one brief comment. While we believe that everyone should try to provide this information in advance, we understand there are circumstances here where lots of information is being brought to light, and that we might be in need to submit this information for illustrative purposes only later.

And I would just like to remind counsel that Ms. Halverson, on the spur of the moment, drew a diagram that none of us had seen before as well, and we had not had the opportunity to review that in advance.

MR. KELLY: I think that that falls outside the requirement, and that is traditionally done in court. But I will happily swap one diagram for the rest of their witnesses for what's going on here.

I think the order, Your Honor, says -- it requires in your special revised order, that all hearing exhibits be provided by April 26th.

And if someone is going to try and use a PowerPoint slide, I am going to demand it be marked as an exhibit so we know what we are talking about. So it is an exhibit.

This argument we are doing it as soon as we could is preposterous. That's the excuse of I am late, well, I am doing it as soon as I can? We can demonstrate why they couldn't do it months or weeks ago at least.

If there is nothing new in the slides, and it is just a summary of their reports and their prefiled testimony, they could have done it by the time of April 26th. If there is something new -- and I certainly don't have the time to try and figure that out -- then it is too late.

So there is no reason why these witnesses can't do what the whole idea of one half hour was, which was to give a summary. The one witness where we used extensive slides was Mr. McCarthy, and they had all of those slides by April 26th.

THE COURT: I am going to enforce the deadline. The slides will not be permitted. Let's continue, please.

MS. DeLEON: Your Honor, the OIC staff will call Gary Tillett to the stand, please.

GARY TILLETT, having been first duly sworn by the Judge, testified as follows:

DIRECT EXAMINATION

BY MS. DeLEON:

Q. Could you please state your full name for the record.

A. Gary Lynn Tillett.

Q. Where are you currently employed?

A. PricewaterhouseCoopers in a transaction services division. I am a partner in that group. Office address 2001 Ross Avenue, Dallas, Texas.

Q. Could you briefly describe your educational background.

A. I have a Bachelor's of Science degree in accounting from the University of Texas at Dallas. I am a

Certified Public Accountant.
Q. And could you please summarize your work experience.
A. My work experience is 22 years with PricewaterhouseCoopers. The last six I have spent in the transaction services group. Prior to that, I was in the audit practice.
With regard to industry experience, I spend maybe a third to half of my time in the financial services industry at this point, a lot on insurance companies. And in the audit practice, for several of those years, I have spent about 75 percent of my time on insurance companies.
Q. Did you prepare prefiled direct testimony for this proceeding?
A. Yes.
Q. Did you also assist in the preparation and submission of PricewaterhouseCoopers Report on Accounting and Tax Evaluation, dated February 26th, of 2003?
A. Yes.
Q. And did you assist in the preparation and submission of a Supplemental Report on Accounting and Tax Evaluation, dated February 27th of 2004?
A. Yes.
Q. Are these reports incorporated by a reference in

your prefiled direct testimony?
A. Yes.
Q. Did you also attach a curriculum vitae to your prefiled direct testimony?
A. Yes.
Q. Mr. Tillett, do you adopt all of your prefiled direct testimony in this matter?
A. I do.
MS. DeLEON: Your Honor, with Mr. Tillett's adoption of his testimony previously filed and served in this matter, we would move for the admission of exhibits S-8, which is Mr. Tillett's curriculum vitae, S-9, which is the Report on Accounting and Tax Evaluation, dated February of 2003, S-10, which is the Supplemental Report, and S-63, which is Mr. Tillett's prefiled direct testimony.
MR. MITCHELL: Could I ask a question on Voir Dire?
THE COURT: Yes.

VOIR DIRE EXAMINATION

BY MR. MITCHELL:
Q. Mr. Tillett, the Accounting and Tax Evaluation of the proposed conversion of Premera Blue Cross of Washington, which bears a date of February 26th, 2003,

except 2003 information which is August 29, 2003, was that report actually produced first in October of 2003, and does the -- would the dates actually refer only to the information upon which it is based?

A. That is correct. The information in the report that is 2002 and prior. The work was substantially completed on February 26th.

The addendum that has the 2003 first quarter information and any other references in the document to '03 information, would carry the date of August 29th.

The way we date our product is with respect to when the work is substantially complete. So the October release of that report is the actual release date of that report. That is the way we date the material.

MR. MITCHELL: No objection.

JUDGE FINKLE: Admitted.

DIRECT EXAMINATION

(Continued)

BY MS. DeLEON:

Q. Mr. Tillett, could you briefly describe what the scope of your -- of PwC's engagement in this matter.

A. Yes. We were engaged to come in and perform due diligence type procedures on the accounting and -- the historical accounting and tax information for Premera.

That would consist of analysis of documentation, interviewing people, and different kinds of procedures that are more analytical in nature to consider the reasonableness or any issues or concerns we might have with the reliability of the historical, financial information.

Q. Could you please discuss your findings.

A. I think our findings are stated throughout the report. First, I would say two things. Our report is not an audit. It is not -- an audit is something the independent auditors Ernst & Young would issue. It does not fall within audit guidelines.

Nor is it a formal examination under the state guidelines. It has similar procedures throughout, and as stated in the report, our findings are there. But I wanted to make that clear.

With respect to matters that are probably worth noting at this time, in the first report that was delivered in October, dated February 26th and August 29th, I think that there are two things worth noting.

First, we noted that the company entered into several sale-lease back transactions over the years, up through '02 and then continuing. That was -- I think, the primary reason was to enhance statutory capital surplus, because certain assets are not admissible under statutory accounting, and therefore, if you sell those assets and enter into a lease, then you can admit the proceeds from that sale.

We did note that with regard to the criteria under generally accepted accounting principles, several of the tests were very close in terms of qualifying as a capital lease, versus an operating lease, which is how they were accounted for under GAAP, and noted that someone could take a different view that some of those tests are close enough or there is enough in the details to question operating-lease accounting.

The effects of that, if someone took a different position, would be that possibly you would have assets and liabilities added to the financial statements for GAAP. For statutory, those rules do not apply. And the reason why it is worth noting here is I think -- should the company file an IPO, and through the SEC review process that gets questioned and thoroughly reviewed -- someone might take a different position.

One other area that we noted in the first report was in the pension area. The company is required annually to obtain an actuarial evaluation of its pension fund, and they do that from an outside independent actuary.

Several assumptions have to be made in those calculations that drive financial results and also get recorded in the financial statements.

We noted that a couple of assumptions seemed aggressive with regard to year-end December 31st, 2002. Particularly, the discount rate used to discount the estimated future liability, and also the long-term rate of return on the asset pool.

The discount rate is less judgmental in our point because there are several indices that exist that you can tie that to, and the rate of seven and a quarter -- and there is some confusion there. Some of the documents we looked at said it was discounted seven and a quarter, others said seven percent, and I will expand on that later. But we thought that discount rate was outside of reasonable ranges at that point in time. So that was one assumption that we thought could change the numbers.

Secondly, the long-term rate, although it is a much more judgmental number, the SEC had commented in recent periods that companies still using an eight, nine percent range might be questioned in the future. Since that time, obviously investments, the markets have come back somewhat, and I think that is less of an issue than the discount rate.

Q. With regard to your supplemental report, do you have any additional findings?

A. Right. The supplemental report -- based on the nature of our work, the only update that we did on the supplemental report was to review the company's 2003 pension valuations. And those were provided to us and we noted two things.

First, we noted that the company reduced the discount rate from seven to six and a quarter for 2003. That, we believe, was within a reasonable range. And while at the high end of a reasonable range at that point in time, was within a reasonable range. Secondly, they reduced the long-term rate of return assumption from 8.5 percent to 7.9 percent.

So we felt that those assumptions were more in line, and therefore the '03 evaluation was more reasonable. However, we did note upon further examination of the detail, that in the actuarial reports provided to us, the 2002 calculation appeared to have a methodology flaw, according to our actuaries -- and I will state, that I used an actuarial partner in our firm to look at this particular issue.

That in calculating the estimated liabilities in 2002, the estimated benefits that were paid in 2002, rather than the actual benefits paid in 2002, were used. And the effect of that was that the estimated benefits were much higher than what was actually paid. Which, by nature of the calculation, would reduce the liability, and we believe that that was an incorrect methodology to use. And, therefore, the '02 number might be misstated from a calculation problem rather than just an aggressive assumption. So those were the two points noted in the updated report.

Q. Are there any other issues that you are still concerned about?

A. I think at this time, given where we are on the calendar, the main issues for us would be, number one, that we haven't really looked at any financial information subsequent to March 31, 2003.

Secondly, the company is up and running on a new system, it has much more of the business on it, which was much less significant at the time we looked at it.

And then lastly, I think when one thinks about an IPO, management should clearly consider the requirements and effects in a controlled environment going into the public arena these days. Those would be our comments. More of an update type of commentary, I think.

MS. DeLEON: I have no further questions.

CROSS-EXAMINATION

BY MR. MITCHELL:

Q. Mr. Tillett, good afternoon. My name is Rob

Mitchell. As I understand your testimony, PwC looked at Premera's books and records and accounting procedures, as a due diligence exercise, as part of the overall financial examination being conducted by the OIC staff; is that correct?
A. Yes.
Q. And the results of that exercise are presented in your reports; is that right?
A. That's correct.
Q. Your initial report, which I think is Exhibit S-9, contains some information which does not appear to relate specifically to your due diligence exercise, and I wonder if you have that before you, sir.
A. Yes.
Q. I am looking at pages 9 and 10 in the executive summary. There is a passage that begins, "Overview." Do you see that there, sir?
A. Yes.
Q. And I believe in the text of the report there is a similar passage on page 21. Can you confirm that for me?
A. Yes.
Q. Now, in those passages, your original report describes Premera as having charitable assets owned by the public in Washington and Alaska. Am I correct in my

understanding that you relied upon Cantilo & Bennett for those factual assertions?
A. What was done -- first of all, can I explain the purpose of why this is in the report?
Q. Actually, if you can answer my question first, I would appreciate it.
A. I think we pulled these facts from the Form A and different documentation and Cantilo & Bennett reviewed this information for correctness. That is the process we followed.
Q. Are you saying that you made an independent determination on these issues?
A. No legal determination was made by PwC. It was information written by my team, reviewed by Cantilo & Bennett for the reasonableness of the information.
Q. So the assertions here are -- insofar as they involve questions of law -- come from Cantilo & Bennett; is that right?
A. Cantilo & Bennett reviewed the information. PwC is not making an assertion of law. They were subject to review.
Q. Now, as the result of your due diligence, Mr. Tillett, you concluded, did you not, that Premera's accounting procedures made sense?

A. I would state it more that nothing came to our attention to say -- other than the items noted in the report and the more significant ones that I just went through in my testimony -- nothing came to our attention as being unreasonable.
Q. And you looked -- as I understand it -- at some of the inter-company agreements that were part of the filing made by Premera; is that correct?
A. The proposed inter-company agreements?
Q. Exactly so.
A. Yes.
Q. And you determined that the terms of those inter-company agreements -- which I will refer to as Form D agreements -- were fair and reasonable; is that right?
A. I think that's stated in the report. There is one exception in the first round of the tax agreement I believe.
Q. Am I correct in my understanding that Premera's most recent financial statements allayed the concern that you had expressed about the pension accounting?
A. I think that the assumptions were definitely brought in line in the '03 financial statements. I would still question whether there may be a problem with the '02 presentation, and how that rolls forward into the '03

valuation we have not performed any work on. So there could be some effects on the '03 financials.
Q. And I think with respect to the other issues you mentioned, the sale-lease back transactions, you said that different people could find those GAAP tests come to different conclusions about whether they were operating leases or capital leases; is that right?
A. That's correct.
Q. If the person reviewing it came to a different conclusion than Premera had, would not the consequence be to make Premera's RVC levels more than they are currently?
A. I don't believe so, because the statutory rules are different, and essentially all leases are operating leases under current statutory code or rules, and therefore, I don't believe it affects RVC.
Q. I take it, Mr. Tillett, there was nothing in Premera's examination books and records that would qualify as a red flag for the Commissioner, was there?
A. I am not prepared to speak -- red flag? I guess I would like a definition of a red flag.
Q. Insofar as this proposed transaction is concerned, Mr. Tillett, would you advise the Commissioner that he should not allow the transaction to proceed because of concerns raised with Premera's books and records?

A. I don't think that that was our specific task, but nothing has come to our attention that would cause me to make such a statement.

MR. MITCHELL: Nothing further.

MS. HAMBURGER: I have no questions.

MS. DeLEON: Nothing.

THE COURT: Thank you. Please step down.

MR. HAMJE: Your Honor the OIC staff would call Don Nemerov to the stand, please.

DONALD NEMEROV, having been first duly sworn by the Judge, testified as follows:

MR. HAMJE: Your Honor, if I could approach the witness and remove one of the notebooks that I don't think he is going to need.

THE COURT: Sure.

DIRECT EXAMINATION

BY MR. HAMJE:

Q. Would you please state your name and your business address, please.

A. Donald Nemerov, 1 North Wacker, Chicago, Illinois, with PricewaterhouseCoopers.

Q. What is your position at PricewaterhouseCoopers?
A. Director in the human resource service compensation practice. We provide the compensation, benefits consulting to clients, both public and private, as well as domestic and global in nature.
Q. Please describe your educational background.
A. I have a Bachelor's of Science in economics from the University of Pennsylvania, and a Master's in industrial relations from the University of Minnesota.
Q. Please describe your experience that is relevant to PwC's engagement in this matter.
A. I am a director in Chicago, and I lead our executive compensation practice in that office. I have collectively around 30 years or so of experience in benchmarking, designing, implementing executive compensation programs, both on a corporate side, as well as the last 15, 18 years on the consulting side.
I have, over the years, worked with numerous companies in the insurance industry. And I am currently an advisor to a compensation committee for a major public insurance company.
I have also had numerous engagements over the years working with companies in the transaction -- various transactions, IPOs, mergers, joint ventures, spins or carve outs of companies, etcetera.

Q. What was PwC asked to do that resulted in your involvement in this matter?
A. We were asked to do a number of things with respect to executive compensation in this engagement. Specifically, there were four questions that we were tasked to answer. One being, will the conversion unjustly enrich executive officers or other outside directors as prior to the conversion. If the executive compensation benefit practices that Premera has are in fact representative of best practices. If the conversion is in fact necessary for strengthening employee retention. And finally, to inform and educate the Commissioner and other interested parties where the non-form of compensation might be of interest to this transaction.
Q. What was the scope of your assignment?
A. Our scope -- we had really two areas of scope. One was on a pre-conversion basis, where we were asked to evaluate the total direct compensation of the executive officers at Premera. And by total direct compensation, that would include base salary, annual incentives or long-term incentives for officers and other senior members of Premera. And also looked at the total cash compensation of other directors and managers within the organization, in terms of the competitiveness to the

market.

We also were asked to examine the executive benefit practices, the programs that Premera has in place with respect to their competitiveness and reasonableness, their change-in-control policy and other retirement plans.

We also looked at qualified plans that Premera maintains for all its employees, including its executives. And we also were asked to complete other -- specialized analyses, which included paid performance analysis, most senior executives of Premera, versus similar companies, as well as some historical analysis of salary growth and employee turnover.

Q. What about post-conversion?

A. Post-conversion scope is primarily focused in a couple of aspects. One, was to look generally at the overall program that Premera has submitted with respect to equity compensation for its executives, often employees and outside directors. And secondarily, was to evaluate the impact of these programs on the compensation competitiveness of the executive officers of Premera, in terms of salary bonus and now the inclusion of stock compensation, how does that impact the total compensation competitiveness.

We also were asked to review, subsequently, the compensation assurances as provided by Premera, Form G-10 -- Exhibit G-10.

Q. Was it Exhibit G-10?

A. G-10.

Q. Did you get a chance to look at the compensation assurances?

A. Yes.

Q. And that's Exhibit G-8; is that right?

A. G-8. Excuse me, that's right.

MR. KELLY: Excuse me, it is E-8. The slide says G-8. It is a typo.

COURT REPORTER: Can you please be sure to speak into the microphone?

Q. What activities did you perform and what did you examine to fulfill PwC's engagement?

A. Primarily, we looked at different peer groups of companies to compare Premera executive compensation to. And that included both publicly-traded companies, as well as, companies within the health insurance industry that have similar size to Premera, and also select to a group of Blue companies that are exactly structured as Premera is today, as a Blue Cross/Blue Shield organization.

We also reviewed quite a bit of information that was provided to us by Premera with respect to their

compensation policies, and programs that they maintain for their executives, as well as, the information provided related to historical compensation and benefits provided to these executives and other officers of the company.
Q. What about post-conversion?
A. Post-conversion we primarily were reviewing the Form A, Exhibit G-10, and the compensation assurances they were provided subsequently.
Q. Did you look at materials provided by Premera?
A. Yes. Some were the plan descriptions, policies related to change control, executive benefits, incentive compensation, etcetera.
Q. In connection with the engagement, have you submitted any reports in this proceeding?
A. Yes.
Q. Did you submit a report in October 2003?
A. That is correct.
Q. Entitled Executive Compensation Review?
A. Yes.
Q. And another report in November of 2003 relating to the Exhibit G-10?
A. That's correct.
Q. And another report in February of 2004, which is a report addendum to your original report; is that right?

A. That is correct.
Q. Have you also submitted prefiled testimony in this matter?
A. Yes.
Q. Have you submitted prefiled direct and responsive testimony?
A. Yes.
Q. Do you adopt your prefiled testimony and your reports?
A. Yes.
MR. HAMJE: At this time the OIC staff offers the following exhibits: S-26, which is Mr. Nemerov's CV, which is an exhibit to his prefiled direct testimony. S-27, which is the Executive Compensation Review, Competitiveness and Reasonableness that Premera Practices, dated October 2003. S-28, which is the Executive Compensation Review Addendum, Competitiveness and Reasonableness of Premera Form A. Exhibit G-10, An Equity Incentive Plan, November 2003. S-29, Premera's Executive Compensation Review, Summary of Issues, Resolved or Pending, Report Addendum, February 27, 2004. S-37, Executive Compensation Review, Corrections and Clarifications to Exhibits S-27, S-28 and S-29, which is an exhibit to Mr. Nemerov's prefiled direct testimony. The next exhibit is S-57 which is

Mr. Nemerov's prefiled direct testimony. And the last is S-58, which is his prefiled responsive testimony.

MR. KELLY: No objection.

MS. HAMBURGER: No objection.

THE COURT: Admitted.

Q. Mr. Nemerov, have you reviewed materials submitted by Premera's expert Towers Perrin?

A. Yes, I did.

Q. Are there any material differences in your methodology regarding how you reached your conclusions as compared to Towers Perrin?

A. There are a number of areas where we do things very similarly as compensation consultants. Many of our tools and methods and data that we apply is very similar.

There were two that I feel were material differences in our approach to this engagement versus Towers Perrin. There were several but there were two that I think were of most material nature. The first area was in how we benchmark compensation.

At Towers Perrin, as Premera's current consultant, Mercer benchmarks the compensation of Premera by taking companies -- Blue companies, health insurance companies, and a select sample of proxy companies, they call public peer group proxies, and they blend it together and come up with a composite, what they call market competitive pay levels. We believe that it is more accurate and informative to present the information separately.

So we are looking at Premera compensation versus Blue companies -- which is what Premera is -- we are looking at compensation versus other insurance companies, and then we are looking at compensation versus a public peer group. Think that gives a much more complete and accurate evaluation of where Premera is versus the marketplace and blend it all together. That would be our one key difference.

And we would also suggest on a pre-conversion basis, when we talk about benchmarking positions that Premera officers fulfill, in all likelihood, the positions are closely matched in terms of the responsibilities with the executives of other Blue organizations. We think since we selected the Blue benchmark as our source of primary reference point for determining the reasonableness of Premera compensation pre-conversion.

The other key difference we had is we completed our own evaluation of the executive benefits and change-in-control policy for Premera. We applied our actuaries in our firm to come up with these evaluations. Our understanding in reviewing the Towers Perrin materials, is that they did not do their own evaluation of those benefits, and in fact, relied more on existing consultants' evaluations of those benefits. We think we did a more complete third-party review of the total package that's offered to Premera executive officers, and in sum total, we believe, that that provides the Commissioner with a more complete assessment of total compensation.

Q. Mr. Nemerov, would you please summarize your pre-conversion findings.

A. Yeah. We had a number of findings, and I am going to focus on the ones that I think are most material to today.

First, we found that -- with respect to other Blue organizations -- that the cash compensation and the total direct compensation -- which would be the cash, plus Premera's long-term incentives paid through their current long-term incentive plan -- is above the market practice of other Blue companies. That's finding number one. And those are -- if I can reference -- those are in our first report, on specific pages of that report. Pages 19 through 21 and 23 through 25 summarize our findings.

MR. KELLY: If I may object. It is transparent that this witness is reading from the slide program that has been prohibited from use. Mr. Hamje asked for it back, and that's fine, I gave him back the other two. And I told him I wasn't going to use them, and destroyed the ones involved here because I had handwritten notes and didn't want to give it back to him.

The witness should not be reading his testimony. He should be giving his own testimony, so I object to the use of this. It is very extensive.

THE COURT: Ask a question. He should answer the question directly if he can. If you need to refresh your recollection, please indicate when you are doing so. Go ahead.

THE WITNESS: Finally --

Q. Let me ask you the question. Do you have -- please continue to summarize your findings.

A. Okay. The second finding that we had with a pre-conversion basis was that -- the organization may perhaps be justified in being above market for a number of reasons. The market is an indicator of reasonableness. It is not an absolute indicator of reasonableness.

Two things that we looked at that validate an above-market condition on a pre-conversion basis. One is performance of a company. If a company is a high-performing company compared to its peers, then being a high-paying company is a natural -- would be a natural result.

In fact, what we found was that on a pre-conversion basis, Premera was not performing -- they were not a low-performing company -- but were not performing as well as their peers, in comparison to how they were paying their senior executives of the organization.

We looked at several different factors in coming up with that evaluation. We looked at operating income. We looked at operating margin. We looked at growth in membership, and subsequently we looked at growth in earnings. So that was our second finding.

Another reason a company might choose or needs to pay above market with respect to its peers on a pre-conversion basis would be that in fact it is experiencing significant issues in attracting and retaining executive talent. I believe that early on, several years ago, I think Premera was building an executive team. But in most recent years that we studied, we did not find that Premera's executive turnover -- talk about executive turnover, let's talk in terms of people voluntarily leaving the organization to go somewhere else, versus being asked to leave the organization. We didn't find the internal Premera officers was problematic. We didn't find that connection.

Finally, we did look at the defined benefit and defined supplemental executive retirement plans, which are provided to selected Premera executive officers, in addition to the qualified benefits. They are significant in value; however, we found they are not necessarily above market competitive practices.

Q. Mr. Nemerov, did you also look at change-in-control benefits?

A. We did study the change-in-control benefits. And the reason that we did is this is a very important part of an executive compensation remuneration in corporate America today. And we do know the conversion, in and of itself, does not cause a change in control. The policies are very clear it does not change in control.

But could there be damage triggered inadvertently or in the absence of a conversion? Yes, absolutely. In as such, these benefits have real value. And the goal of change-in-control -- as I think Mr. Callan has said in his earlier testimony -- is to ensure that the executives act in the best interest of the organization, in case there is an offer to buy the company, and not be worried about their employment long term. So it provides a severance benefit to the executives to ensure that they don't act out of accordance with what perhaps

the majority of people might have.
And also the change-of-control benefits also assure during this transaction there is reasonable retention of executives. But the fact is, these benefits do have significant value.
Q. Did PricewaterhouseCoopers attempt to estimate the value of the change-in-control benefits?
A. Yes, we did.
Q. At this point, I am going to ask you what the value was, but I would rather -- I don't believe it is necessarily something that is for public consumption.
So what I would like to ask you to do, instead of answering my question, would you -- I believe, if you have got a note there, if you can tell the Commissioner where the evaluation may be located among the materials that you have submitted to the Commissioner for his review, rather than stating it out loud.
A. Okay. In our first report, S-27, on page 26, we have a variety of evaluation of the change-of-control benefits to prove to the executive officers of Premera -- this would include the CEO, the other executive vice-presidents and the senior vice-presidents.
Q. Do you make an assumption with respect to developing that value about the executives staying or leaving?

A. Well, the value assumes, of course, this is what the payment in aggregate would be if all executives were to be terminated as a result of a change in control.
Q. Are there any other provisions relating to the change-in-control benefits that should be brought to the attention of the Commissioner?
A. Well, the only other -- I mean, we found overall that -- when we add it all up, that for a private company on the pre-conversion basis that the benefits are very -- at market to above market.
There is also a provision in there that was talked about several days ago with Mr. Furniss where the CEO and the EVPs have what we call the walkaway right. Where, within one year after change in control, where they had been taken over by another company, they can leave at their own volition and not have to be constructively terminated to receive a change-in-control benefit. The benefit is reduced by 50 percent of what they would normally receive, should they be constructively dismissed and receive the benefit.
Q. Mr. Nemerov, if you would be kind enough to refer to a notebook that's in front of you. I would like you to turn to Exhibit S-75, please. Have you located it, sir?
A. Yes.
Q. Would you please identify it.

A. This is Premera Blue Cross, Change-in-Control Provisions, Version, October 7th, 2002.
Q. Is this the most recent version?
A. This is the most recent version we have, yes.
Q. Was it provided to you by Premera?
A. Yes.
Q. Did you rely upon it in making your findings?
A. Yes.
MR. HAMJE: At this time the staff would offer Exhibit S-75.
MR. KELLY: No objection.
MS. HAMBURGER: No objection.
THE COURT: Admitted.
Q. Mr. Nemerov, would you please summarize your post-conversion findings.
A. Yeah. On a post-conversion basis, we are looking at Premera versus a group of publicly-traded health insurance companies, as well as the insurance companies in Blue organizations.
On a post-conversion basis, Premera falls below the median of the publicly-traded peer group, in terms of total compensation, salary bonus and long-term compensation. And the primary reason for that, of course, is that the value of the equity incentives provided to companies in the public peer group.

We found that for companies of similar size in the insurance industry, in the health insurance industry, Premera will still be -- will be a head above market. And of course to other Blue organizations with the inclusion of equity incentives, Premera would be well above that peer group.

Q. Mr. Nemerov, are there any other executive compensation issues remaining that you believe are significant and should be noted with respect to this proposed conversion?

A. There are two issues we identified. First, I will say that with respect to the equity incentive plan and the provisions contained within that plan and the plan of stock grants that Premera estimated, we have come to an agreement that we feel those provisions are all in line with market standards.

There are two issues that remain. Issue number one has to do with the long-term incentive plan. The issue with the long-term incentive plan is that this is probably -- between now and the time Premera converts, one of the most important programs that -- of executive compensation in that organization is the transition -- or should they transition successfully from a public to a private company.

We are concerned -- and it is a very meaningful program. It is a program that, every year, the executive gets an opportunity to earn compensation based on performance against goals for over a three-year period. It is a very common program to have in place in a private company as a way to provide, in lieu of stock compensation, long-term incentives to senior management teams. It is a very important program and very -- part of the competitive compensation structure.

Our concerns with the long-term incentive plan relate to goal setting that has occurred with respect to triggering award pay-outs, in that the plan is funded based on the profitability of the company, which is logical in a private situation as it is today. However, we are concerned that the minimum goals that we set to fund the plan are below what we typically see for a plan of this nature.

The second issue we have with this program is that it has got a very unusual provision in it that allows the participants in the program to have their incentive pay-out grow, commensurate with their salary increase, over the period of time from which the award is initially granted, to that which when it is finally determined. That is very unusual.

Normally, you will have a program that says you will have an opportunity to earn a certain amount of money if you achieve these goals, and that's the beginning, the middle, and the end of the conversation. And the award might vary, certainly, based on performance, but that is it.

This program, actually your opportunity grows after you received the opportunity based on your salary growth, and we find that very unusual. And coupled with the low minimum that's established for funding the awards, it is a little bit of a double whammy. We have some concern with the design of the program.

When we looked at other companies in the industry -- particularly in a post-conversion basis, that have these kinds of programs -- and they aren't common in the public arena, less -- very few of the peer group in the public companies maintain these programs -- they maintain very rigorous standards for awarding payoffs over a long-term incentive plan. Most of them use our earnings per share growth, something to ensure there is an alignment between payoffs under this program and what will accrue to shareholders and other important constituents of the company.

Q. Mr. Nemerov, did you have any other issues that you wanted to bring to the attention of the Commissioner with respect to executive compensation?

A. The other issue we would raise -- and this is more of an observation -- that, historically, Premera has provided salary increases to their executives, in our assessment, is above-the-market norm. It might have been prudent in a pre-conversion private setting to attract and maintain the kind of talent they need.

We note that all of Premera's executive compensation programs are driven by salaries. And to the extent that salary growth in the future continues at the rate it has occurred in the past, that you will be increasing the cost of a lot of other programs post-conversion, including the non-qualified benefit programs, as well as the change-in-control. The value of the change-in-control payment will go up as a result of salary growth.

So we have noted that there is some risk prospectively, that if salary growth for the senior people in the organization continues at that level, we could have significant growth in non-performance based compensation post-conversion, to a very significant extent.

Q. Do you have any recommendations to resolve or mitigate the issues relating to the long-term incentive plan?

A. Our suggestion on the long-term incentive plan is two-fold. We would suggest, number one, that Premera eliminate the provision that allows the amount of the executives' pay-outs to grow based on salary to stop prospectively.

So when opportunities to earn incentives is made, the opportunity to earn incentives is calculated based on what was granted as of the grant date and not at the award date. That would eliminate some upside pay-out that has nothing to do with the performance of the organization during the performance period.

The second recommendation we have is, absent some agreement as to what a reasonable minimum performance level is for funding incentives, we would suggest that, during the restriction period, that perhaps Premera adopt a provision that would provide that a minimum shareholder return occur during this time period prior to triggering pay-outs.

Our logic for that would be, of all the programs Premera has for its executives, the long-term incentive plan is the one that's the closest to -- we should align with shareholder value, and align salaries and annual incentives or benefits. And this would assure that pay-outs that would occur under the long-term incentive plan would have some alignment during restriction period, post restriction period, to the shareholders.

Q. Mr. Nemerov, do you have any recommendations on how to resolve or mitigate the issue related to officer-based salary growth?

A. Our suggestion there is that -- we aren't suggesting that the other programs that are currently being placed, the opportunities or the benefits being provided be reviewed. We are suggesting to facilitate, if you would, a shift to more performance-based compensation, that Premera adopt a provision or consider that they will reduce the growth of salaries for their executive officers to levels commensurate of their peers and not above their peers. And that would dampen, if you would, growth in these other programs and allow Premera to focus increased compensation opportunities on incentive pay.

We would note that in the proposed conversion Premera has proposed increasing the opportunity that they would provide under the current long-term incentive plan, that of course post-conversion they will get a new opportunity that they don't have today, which is of course the stock compensation, that they currently do not have, which is very significant.

Q. Do you have any final conclusions?

A. We think that many of the things that -- we have been through a lot of discussions with Premera, that many of the issues we may have initially had have been resolved. And they have been responsive in a number of areas with respect to the equity incentive plan -- it satisfies us -- we believe are within the range of market standard.

We think that the two recommendations we have only serve to strengthen the compensation for executives at Premera, and we think a more rigorous and shareholder-linked, long-term incentive plan would be good for the shareholders, and it will be good for the organization, it will drive -- it will focus on performance. And we think that a moderation of base-salary growth will accelerate the shift to more performance-based pay as Premera moves through the conversion process and then ultimately is a public company.

Q. Did you have any further comments for the Commissioner at this time?

A. No, I do not.

MR. HAMJE: At this time I pass the witness.

CROSS-EXAMINATION

BY MR. KELLY:

Q. Good afternoon, Mr. Nemerov. I had some questions I wanted to get to, but first let me ask you questions following your outline here.

Now, you, yourself, did not do your evaluation of the benefits program; is that correct?
A. You mean, me personally?
Q. Right, you used someone from Saratoga Springs or something like that. What is it called? The company that PwC -- Saratoga --
A. Saratoga did the analysis for executive turnover.
Q. Okay. So you had someone else in your office do the analysis of the benefits program?
A. Yes. That was performed by retirement actuaries within the Chicago office of PricewaterhouseCoopers.
Q. Do you recall that Mr. Furniss in his testimony or his report indicated that he turned to those counterparts in his office to review the compensation benefits programs?
A. My understanding was he relied on Watson Wyatt to do the benefit valuation.
Q. Watson Wyatt had already done a benefit valuation as an outside consultant of Premera; is that correct?
A. Yes.
Q. And Watson Wyatt is a well-known benefits and executive comp firm; is that correct?
A. Absolutely.
Q. Okay. And did he not say that, in addition to that, he turned to his own counterpart on the benefits side at

Towers Perrin to look at what had been done by Watson Wyatt?
A. I don't recall that he had someone in his office do that.
Q. Now, let's turn for a minute to the issue of change-in-control benefits. So these are the benefits that are calculated when -- if there is a change-in-control, another company comes in and takes over and doesn't want to have these executives anymore, and they lose their jobs. Then they get a payment for -- based on their salary, and they also get a payment based on their benefits; is that correct?
A. The parts that are included in the calculation will be the individual salary, their annual long-term incentives, and their supplemental benefits.
Q. When you say the benefits that these executives have now are at market, you were referring to that they are at the median; is that correct?
A. They are in that range of the market, yes.
Q. Now, you also ask -- were asked about the walkaway rights. Another way to look at that is the stay-on duty or right. Would you agree with me?
A. Explain that.
Q. Well, would you agree that one of the benefits of that walkaway provision for the company is that it may

encourage the executives not to abandon ship immediately when someone else takes over, but to continue in the job for up to a year to provide a transition so the company continues to perform and progress.

A. That can be one benefit of the walkaway right, yes.

Q. Because, otherwise, if the individual thinks he or she doesn't have much future in the new company, then they may just start looking for a job, isn't that true?

A. Other than -- absent the walkaway right, the genesis of the walkaway right, where it is most commonly applied, is for the CEO position. The logic of that is that there can't be two CEOs.

Q. Let me ask you this, would you happen to be present when Heyward Donigan testified?

A. Unfortunately, I missed a portion of that testimony.

Q. Did you happen to see Brian Ancell when he was testifying?

A. I didn't see him either.

Q. Did you see Mr. Marquardt testify?

A. I saw bits and pieces of his as well.

Q. Do you think it might benefit a company to be able to retain people like Ms. Donigan, Mr. Ancell, and Mr. Marquardt, even though they aren't the CEO, if and when a company is taken over so the company can continue to function?

A. Yes. But I am not sure how that relates to the walkaway right though.
Q. Well, if they don't have a walkaway right, there is no reason for them to hang around for a year, is there?
A. It is a job.
Q. Well, I guess if you think that life is just a job, that is certainly the case.
A. Well, it is a job, and if they are still senior executives in the new organization, in all likelihood, they are receiving new benefits as a senior member of the new organization.
Q. Now, the concern you had about the fixing of an incentive pay, that is something that would be discussed for -- it would be proposed for post-conversions, is that what you are saying?
A. Which piece?
Q. Well, let's see. You were saying that -- for the long-term incentive plan you were concerned about how it was actually calculated, what the base was, and that you thought it should be fixed at the beginning of the award? Do I have that right?
A. That is correct.
Q. Okay. And your proposal is that for any new, long-term incentive plan after conversion, that there should be a -- that the approach that should be taken

would be to fix the award at the beginning of the plan?
A. I would suggest at the earliest possible date that that be fixed. If that's post-conversion, then that would be the earliest possible date.
Q. These long-term incentive plans are called long-term because they are three-year plans; is that correct?
A. That's correct.
Q. Now, you did talk about, in addition to shareholders, other important constituents. Did you have the members in mind there as possible important constituents, in terms of making sure that the executives are doing things that are good for constituents?
A. Members are an important constituent.
Q. And then I will get a little bit more into salary increases. But what you are saying is that historically the Premera executives have -- for over the last couple of years -- gotten higher than average increases in their salaries; is that correct?
A. That is correct.
Q. And you understand that the rationale was to bring them up to median; is that correct?
A. Up to a -- what the board and committee felt was where they had to be in the marketplace.
Q. Okay. So there is no particular reason for you to

think -- or anyone to think -- that whatever trend had existed to get them up to market, was now going to continue on after they reached market; isn't that true?
A. That would be speculative.
Q. Well, you certainly -- if you were con -- being a compensation consultant to the Premera compensation committee, would say to them, look, it made sense to bring them up to market because they have been underpaid in the past, but that's not going to be a trend for the future. Isn't that the first thing you would say to them?
A. That would be one of the first, yes.
Q. Okay. Now, one other thing, just to be clear as we get into more detail in cross-examination, your suggestion on the LTIP and connecting it to some sort of minimum share performance, I believe the word you used was "during the restriction period;" is that correct?
A. I believe so.
Q. And the restriction period that you are referring to is the 12 months during which Premera has agreed that none of its executives will be able to obtain any stock options; isn't that correct?
A. That is correct.
Q. But long-term incentive plans are three-year plans. So this restriction -- the LTIP for one year would not

work for a three-year plan situation, would it?
A. That wasn't what I was saying.
Q. If you would just answer my question. An LTIP -- a restriction or a connection to minimum share performance for one year would not work for a three-year plan, would it?
A. I didn't say that though.
Q. I know you didn't say it. I am asking you what the situation is. And LTIP, with a minimum share performance requirement for -- would not work for a three-year plan, when you have a one-year restriction period; isn't that true?
A. That is true, but that's not what I said.
Q. I know you didn't say that. I said it, and I asked you if it was true, and you told us it was true. Okay? Okay. I would like to ask you a few questions about the peer groups.
You do agree that the relevant labor market for executives should be other companies that a company can recruit from or could lose talent to, do you not?
A. That should be part of the labor market.
Q. And, now, you never interviewed any of the executives at Premera, did you?
A. That's true.
Q. So do you know where those executives came from

prior to their getting the job at Premera?
A. We have their work history.
Q. Okay. Well, where did Mr. Barlow come from?
A. I can't recall each one. But I know that some came from other companies, east coast, west coast, public, private.
Q. In fact, Mr. Barlow came from a public company; isn't that true?
A. Right, I believe so.
Q. Ms. Donigan, do you remember where she came from?
A. I believe she came from Empire.
Q. New York City?
A. Right.
Q. Okay. And she was with a public company; is that correct?
A. I think she had been with both public and private companies.
Q. Mr. Marquardt, where did he come from?
A. I can't recall where Mr. Marquardt came from.
Q. If I told you it was a public company, would you accept that?
A. If you told me the name of the company.
Q. Now, let me ask you this. Does it not appear that Premera, in seeking qualified people to run the company and to improve it, have reached out to not just Blues,

but to health insurance executives, across the country, in both private and public companies?
A. That's true.
Q. Okay. And Mr. Furniss says that that's the way it ought to be and that is appropriate then to see what other public and private companies will do to pay compensation. Is that a fair statement of what he said?
A. I believe that is his perspective.
Q. Okay. Now, as you said, you and Mr. Furniss do have a number of points in agreement, do you not?
A. That's true.
Q. Although, I guess you are concerned about the percentage increases in base salary, you agree that the base salary for all of the Premera executives is currently reasonably competitive; isn't that true?
A. If I recall, their salaries were in the range of market competitiveness.
Q. Well, but didn't you use on page nine of your February 2004 report the phrase, quote, "Currently reasonably competitive," end quote when describing base salaries for these executives?
A. Yes.
Q. Thank you. And you understand that Premera's philosophy of its compensation committee is to aim for the median, unless there is a good reason to go above

the median?
A. That is my understanding.
Q. As a matter of fact, you testified at your deposition that you were, quote, "In accord with that," end quote; isn't that true?
A. I don't recall those exact words, but I will take your word for it.
Q. If you doubt it I would be happy to show you --
A. That's fine.
Q. Now, in regard to pre-conversion compensation benefits, when compared to other health insurance companies, both public and private, your conclusion was that Premera was more at market; isn't that true?
A. The executive benefits?
Q. On the executive benefits, yes.
A. Yes.
Q. And I think you testified earlier -- but just to make sure I heard it right -- that compared to peer groups for post-conversion, Premera is, quote, "At or below market in terms of its benefits;" isn't that true?
A. I don't think I said that in terms of benefits.
Q. Okay. Well, let me check.
A. Yeah.
Q. I forgot to look at the context of it. I think that's what you said, but let's see. I guess we will

need to publish your March 8th deposition.

MR. KELLY: Do you do the opening?

THE COURT: I just rip it.

MR. KELLY: Do you have a copy?

THE WITNESS: Not up here with me, no.

Q. Do you want to take a look at -- I think you probably want to start at page 105 and then go over to page 106.

THE COURT: Do you have another copy just in case there is an issue? Ask a non-controversial question and there won't be an issue.

MR. KELLY: I think we may. I am happy to hand mine up.

THE COURT: You can try it, and if there is an objection --

MR. HAMJE: We are trying to locate it. We think we have a copy if you give us just one moment.

THE WITNESS: I do have one, it is just not right here.

BY MR. KELLY:

Q. That's fine. Why don't you -- while we are waiting -- spend your time reading on 105 and then over to 106. I want to ask you at the bottom of 106. Spend a moment and read through it.

A. Okay.

MR. KELLY: John, do you want me to wait until you get your copy? We can do that, that's fine.

MR. HAMJE: I have it. I have a copy right now that I can share with you.

THE COURT: Thank you. Go ahead when you are ready.

BY MR. KELLY:

Q. Have you had a chance to read through pages 105 and 106?

A. Yes. I have read through it.

Q. And was that -- was the questioning there not -- was it in the context of compensation benefits, which were based upon base salaries, and then would go up or down depending on what the base salary would be?

A. There was discussion of base salaries.

Q. All right. And then at the bottom of the page didn't I ask you about other compensation related to base salaries?

A. On page 105.

Q. The bottom of page 105.

A. Right.

Q. And then didn't I ask you in the middle of page 106, at line 9 and 10, asking you about the executive compensation and benefits programs that Premera has?

A. Right.

Q. And then didn't I ask you -- at the bottom of page -- of 106, lines 21 -- "Compared to Premera peer group that's contemplated in Exhibit 8, they would certainly be at or below market; isn't that true? Answer, "That is correct."
A. I was responding -- as I read that -- we were talking about their direct compensation, was my understanding of the question.
Q. Okay.
A. Yeah, not the benefits. That was my understanding of the question as I read this.
Q. Now, let me ask you this, the purpose of a peer group is to make competitive adjustment to compensation; isn't that true?
A. It is one reference point, yes.
Q. Isn't that one of the reference points that you testified to at page 107 of your dep?
A. A peer group is important.
Q. And you do point out the impact of base salary on benefits to all of your clients, do you not?
A. That's true.
Q. Okay. And what your point is -- a pretty obvious one, I think -- is that if benefits are linked to base salary, if base salary goes up, there is going to be an impact on benefits; is that true?

A. That is correct.
Q. And you have no reason to believe, by the way, that the -- Premera's compensation committee would not understand that point?
A. I have no reason to believe they would not understand that point.
Q. And you have every reason to believe that they take it into account even now when they are saying, well, if we are going to give an increase in salary, it is also going to have a bump on benefits?
A. That, I have no insight to.
Q. And you have no insight, in part, because you never interviewed anyone from the compensation committee; isn't that true?
A. That is true.
Q. Now, were you here this morning when Mr. Martin Alderson-Smith testified?
A. No, I was not.
Q. And -- well, let me ask you this. If he testified that he had no hesitation that the board of Premera will follow its best practices right from the beginning, would you say that that also -- that his testimony also comports with your view of what Premera's board will do?
A. I would have no perspective to believe that they would not act in the best interest of the organization.

Q. Okay. Now, let's move on to another aspect of the current plan, the annual bonus plan. This is a bonus that is designed to get executives to hopefully work hard for the shorter-term objectives of the company; is that correct?
A. This is the -- are we on the annual incentive plan?
Q. Yeah. Right. Is that the purpose of it?
A. Focus on the performance for that year.
Q. And your description of that, or review of it, was that it was, quote, "a fairly typical plan;" is that correct?
A. I thought it was -- I don't recall that with respect to --
Q. Annual form?
A. Where do you see that?
Q. Well, I think you said it at page 168 of your March deposition. Do you agree with that point, in any event?
A. The annual incentive plan?
Q. The current annual incentive plan is a fairly typical plan?
A. In other words, it is structured in a fairly typical fashion.
Q. Okay. Now, let's talk for a minute -- I am trying to work my way through the various components of the plan -- of the compensation. Let's talk about long-term

incentive plan. The way the long-term incentive plan currently at Premera works is you have a financial goal, which forms the basis of the plan, which is based upon operating income; is that correct?
A. That is correct.
Q. Okay. And then the -- in order to -- there is a target that is set; is that correct?
A. For the three years, yes.
Q. And if you reach the target, then you are able to get 100 percent of the financial component of the plan; is that correct?
A. You get a hundred percent of your award.
Q. Of the award. Well, isn't there a caveat on that, that you have the potential to get a hundred percent of your award, but that award can be reduced if, even though you made the operating income target, you did not make the other performance targets, such as customer satisfaction, membership growth, or whatever else is set as a non-financial objective?
A. My understanding of the plan in reading the document is your award can go up or down based on achievement of those goals.
Q. But the point is that if you -- merely because you make the financial target, you still have to go through an additional hoop of making or trying to make the

non-financial targets as well; isn't that true?
A. You have another component to your compensation plan.
Q. Not just -- let's talk about this. Some companies have a financial component to their long-term plan, where if you hit target you get that much -- you get an award; is that true?
A. Are we on the long-term or the annual plan?
Q. Long term. Yeah.
A. You are done with the annual?
Q. It is a fairly typical plan, isn't it?
A. The long-term plan?
Q. No, the annual plan.
MR. HAMJE: Objection, asked and answered.
Q. There isn't that much more to ask about it, is there?
A. Okay.
Q. What I am trying to ask you, is there not two different types -- or approaches at least -- of long-term compensation plans. In one of them, you have a linkage between financial component and non-financial performance, in the other, they are separate. If you hit your operating income target, you get some money. If you hit your membership, you get some money. The two are not linked whatsoever?

A. There are a number of variations to long-term incentives.
Q. But in this one, Premera links -- not only have to make your operating income, but if you really want to get the full potential out of that operating income award, you also have to do well on financial -- on non-financial measures; isn't that true?
A. There are non-financial goals set as part of the plan.
Q. Well, I understand they are goals, but they are goals with implications, are they not? It means, if you don't meet the goal, you get less money.
A. Or more.
Q. You say more, and that's contested; isn't that true?
A. I am going by the plan document.
Q. As you understand the plan document?
A. As literally written.
Q. Well, I am not going to debate with you how it is written, we will see how that ultimately comes out.
A. Right.
Q. But let's talk about that. You don't have any problem with the fact that if a person meets their financial goals, and then also does even better than they had to in terms of customer satisfaction, if your interpretation of the plan is correct, that they get an

additional award for that, do you?
A. I don't have an issue with it. It is not -- it is more atypical.
Q. Okay. So -- and would you not agree with me that when Premera links -- not only the financial performance, but also requiring a non-financial performance -- that that is a more conservative plan, because you have to perform more in order to get the money?
A. That answer would depend on evaluation of the difficulty of the goals.
Q. We will talk about that in a little bit. Now, you do agree that non-financial performance measures are factors that should be considered in executive compensation plans, do you not?
A. I believe they have a place in the executive compensation, yes.
Q. Okay. But when you testified under oath last time, you said that they should be considered, did you not?
A. Absolutely.
Q. Okay. In fact, you put it pretty well, didn't you, when you said, "If you don't have members or customers, you are in trouble;" is that correct? Do you remember saying that?
A. Yes.

Q. And then I said, "If you are in trouble, your stock is in trouble." Do you remember what you said in response to that?
A. I don't recall, but I remember that conversation.
Q. You said, "Right," didn't you?
A. I believe so. I am sure I did.
Q. Let's turn for a minute to the stock grant. I think you have already indicated that the stock grant program or the equity compensation plan, you believe, is appropriate; is that correct?
A. (Witness nods head.)
Q. This is post-conversion.
A. Yes.
Q. And you have no difficulty -- you have been talking mostly about executives, but in your report you also agreed that the stock option program for directors was also at the median; isn't that correct?
A. That is correct.
Q. Could you take a look for a minute at S-29, that's your February 27th, 2004, report, and if you could take a look at page two. And do you have that in front of you there?
A. Yes.
Q. And under, "Overall Conclusions," you indicated that the changes -- I think as you testified -- "...represent

significant and positive progress..." and "...are more aligned to the interests of shareholders and address many of the concerns raised by..." you "...and other..." people; is that correct?
A. It is right here.
Q. Right. Okay. And sorry to jump around like this, but if you could turn for a minute to S-58, which is your responsive prefiled testimony. Do you have that in front of you there?
MR. HAMJE: Again, this was one where we had -- there are -- we provided it, as we had initially agreed, that we would provide the first page of each of these documents. We had already provided, I think, bench copies for everyone.
MS. SUREAU: We figured it out, John.
JUDGE FINKLE: It is not your fault.
MR. KELLY: Do we all have it?
THE COURT: Not quite.
MR. HAMJE: Prefiled responsive testimony.
THE COURT: Okay, we are with you.
MR. KELLY: Very good.
BY MR. KELLY:
Q. Now, I just wanted to draw your attention, Mr. Nemerov, to paragraph two, and these are the -- this is what I guess you would call your firm's point of view

about executive compensation; is that correct?
A. That is correct.
Q. And you enumerate actually, or your firm does, four factors to consider for executive compensation. One is align with a company's business strategy. Two, competitive as-needed to attract and retain leadership. Three, primarily performance-based, but doing so without hampering the company's ability to retract and attain executives. And four, to have an independent compensation committee that oversees the design and administration of programs that ensure that shareholders and other key stakeholders are represented. Is that a fair summary of your firm's point of view?
A. That is correct.
Q. And it is fair to say that that is just about the same as the point of view presented to us by Mr. Furniss at Towers Perrin; isn't that true?
A. I am not sure he had a firm point of view that I recall.
Q. But those are the very principles that he repeatedly talked about in his reports, and in his prefiled, and in his actual live testimony; isn't that true?
A. To some extent, yes. I don't recall exactly.
Q. We will get to that probably in a few minutes. But let me ask you -- you raised a concern about officer --

not a concern about officer turnover. I guess your point now is that there doesn't appear to be any current problem or recent problem with officer turnover, and therefore, that wouldn't be a justification for raising salaries? Is that -- do I have that right?
A. I don't know if I went right -- to that way, said those words, did I?
Q. I am not comporting to precisely repeat your words, sir. Why don't you tell us what your point was about officer turnover at Premera.
A. The points that I stated was that it has not been an issue in recent years.
Q. Uh-huh.
A. That was point one.
Q. Okay.
A. Point two, as I said earlier, excessive and unwanted officer turnover might lead an organization or Premera to be a higher payer in the marketplace.
Q. All right. Okay. But the -- now, there have been some significant changes in Premera's leadership, in fact, the CEO left just a few years ago; is that correct?
A. I believe so.
Q. Okay. And when you were originally talking about officer turnover, it was in the context of would there

be an additional benefit to a conversion if there was the added benefit of having stock options to eliminate or reduce the likelihood or possibility of officer turnover; isn't that correct?
A. Way back, the officer retention was an issue that was raised sometime back, that this would be a benefit -- on the part of Premera or somebody presenting to Premera, that this would be a benefit to improving officer retention, the availability of stock compensation.
Q. Right. And we went through a long discussion, and it turned out that was your interpretation of what had happened, it wasn't really what Premera was moving for in this case; isn't that true?
A. There was a discussion on it.
Q. It is over and done?
A. Over and done.
Q. Very good. Now, if you will bear with me, if you would turn to report P-52, if you have that, that's Mr. Furniss's second report?
A. P?
MR. HAMJE: I don't think he has P-52. If you don't, we will get you a copy.
MR. KELLY: We will also need P-53 while we are at it.

MR. HAMJE: May I approach the witness?
THE COURT: Yes.
Q. Okay. Now, P-52 is Mr. Furniss's second report and that addresses, does it not, each of the issues that you had raised in your February report?
A. Yes.
Q. Okay.
A. Response to that, yes.
Q. So if the Commissioner and staff are looking at your other reports, that would be the correlation back to.
A. It is correspondence to my February 27th report.
Q. Right. And then P-53, which is Mr. Furniss's responsive testimony, addresses your March corrections report; is that correct?
A. I believe that's the sequence, yes.
MR. KELLY: Okay. That's all I have on that.
THE COURT: How much longer do you expect to be?
MR. KELLY: I would think probably about another 15 minutes.
THE COURT: Let's take a break.
MR. KELLY: Okay.
(Afternoon recess.)
THE COURT: Please continue.

MR. KELLY: Okay. Thank you.

BY MR. KELLY:

Q. Mr. Nemerov, I have just three areas I would like to cover -- hopefully, pretty quickly -- with you. First is in regard to some concern that you raised about the Premera's financial performance. You were saying because of your view that it wasn't particularly good, that you did not think that Premera's pre-conversion compensation was necessarily justified. Is that a fair summary of what your thinking is there?

A. Yes. And what I said was their pay versus the Blue companies was higher than -- on an relative basis than their performance, versus that same group.

Q. You collected a bunch of information from the AM Best Key Rating data file and base and from regulatory files; is that correct?

A. That is correct.

Q. Now, let's talk about Premera's performance over the last couple of years. Are you aware of what its current RVC level has gone from -- say, going back from 1997 or so -- to current?

A. No, I am not.

Q. Would you be surprised if it has improved in that time period?

A. I haven't reviewed it.

Q. Okay. Were you present when Mr. Koplovitz testified -- I guess it was yesterday or Monday?
A. Parts of it.
Q. Do you remember him saying he thought Premera was a strategic, forward-thinking company, well-positioned to do successful -- to do a successful IPO?
A. If he said that, then he said that.
Q. Doesn't that translate to you into a well-performing company in his testimony?
A. I am not -- I don't know if I would make that connection, but he said strategic -- repeat that.
Q. If it is a poorly-performing company, as you would have us believe, why in the world would it be successful in an IPO, and why would an investment banker say it would be successful?
A. I didn't say they were poorly performing.
Q. Didn't Mr. Koplovitz indicate that they were actually performing quite well in terms of operating income efforts?
A. They have been improving, yes.
Q. Now, were you aware of the serious problems that Premera faced in the mid to late-1990s?
A. I have heard of those issues, yes.
Q. Were you aware that the financial condition had deteriorated in 1997 to the point where the OIC, such as

Deputy Commissioner Odiorne asked Premera's senior management to personally appear at the office and explain what they planned to do with their financial position?

A. I am not aware of that specific event.

Q. Okay. Well, assuming it occurred, would you agree with me that there has been a real turnaround in that company over the past several years?

A. Yes.

Q. Doesn't that turnaround indicate to you substantial improvements in performance of the company?

A. The company's performance has improved over the years we have studied.

Q. Now, starting in 1998, what was the operating income of Premera?

A. I don't have those notes in front of me.

Q. Okay. Well, let me see if you agree if I may approach the -- if I speak loud will that be okay?

THE COURT: You might take a Lavaliere just to help the folks in the back.

MR. KELLY: Okay.

Q. Well, was it a positive or negative operating income in 1998?

A. I don't recall.

Q. Okay.

A. If you tell me --
Q. Would you agree that it was negative 21.9 million dollars?
MR. HAMJE: Excuse me, I think there is something wrong with the microphone.
THE COURT: If you move it up a bit it might work better.
Q. Do you agree with me it was negative 21.9 million dollars?
A. I accept that if that's what you are putting down.
Q. Well, for 1999 -- you were the one who made a comparison study.
A. Right.
Q. Based upon some data; is that correct?
A. Years 2000 through 2002.
Q. Okay. Is there any particular reason that you chose those years as opposed to the earlier turnaround years?
A. Yes.
Q. Well, let's get to those in a minute. Let's just put down for the record 1999, 13.4 million, does that sound about right?
A. It sounds about right, yes.
Q. 2000, 13.7 million, does that sound about right?
A. Yes.
Q. 2001, 27.9 million. Is that one of the figures you

were looking at?
A. Yes. Our numbers are a little different because of the differences in reporting between AM Best and their financial reporting.
Q. Aren't there substantial limitations on the depth with which the AM Best established regulatory filings, which I think you also used?
A. They are one source of data. They are accepted as credible.
Q. If you had a better source, you certainly would have followed it, wouldn't you?
A. I am sorry?
Q. If you had a better source, such as data from the company itself, you would certainly want to utilize that before you accuse the company of not performing well?
A. We used AM Best which had data on all companies.
Q. 2002, the figure was 35.6 million. Do you remember that?
A. Okay.
Q. 48.4 million, is that about right?
A. Yeah.
Q. And you understand budget estimate was 58 million for 2004.
A. I would have to see my notes, but that sounds about right.

Q. Okay. Now, the three-year LTIP targets would require us to add plus two years for each one of these numbers; is that correct? In other words, it is 1998 to 2000, then 1999 to 2001 and so forth. Do you understand what I am trying to describe?
A. You would add those together to come up with the goal, if you would, for that three-year period.
Q. Instead of trying to write out three things, I am going to use this for both the one-year operating income, and then the LTIP target for that year and the following two years. Does that make sense?
A. Sure.
Q. What was the LTIP target back in 1998 for this company?
A. I don't have that number -- based on these numbers?
Q. Yes.
A. These are actual results, right?
Q. Right.
A. So I don't know what the target was.
Q. Okay. Why wouldn't you know --
A. I just have those numbers in front of me.
Q. Target was zero at that time since they were in the red and wanted to reach at least zero?
A. Are we trying to reconstruct the goal for --
Q. I am actually trying to get the data on what the

actual LTIP targets are, because I think you have a problem with those targets, don't you?
A. We had a problem with the minimums.
Q. Okay. Well, you first need to know what the targets are in order to find the minimums; isn't that correct?
A. The minimums were set relative to target.
Q. I understand. Let's start with targets, and then if you have data we can get to that as well. 1999, the target was 40 million dollars; is that correct?
A. I believe that sounds correct, yes.
Q. And 2000, the target was 63 million dollars; correct? 2001, 93 million; are both of those correct, sir?
A. Sounds correct.
Q. Okay. Does it sound like 123 million was the target for 2002, 153 million for 2003, and 212 million for 2004? Do those sound correct?
A. I haven't received '03 and '04 plans, so I don't know.
Q. Okay. Now as I understand it, the minimum is something like 80 percent of the target; is that right?
A. No, that is not right.
Q. Okay. Did you ever produce the actual targets in a comparison such as I have just put up here, and/or the minimums, in any of your papers?

A. We do have a comparison of our minimums and targets.
Q. You don't have it in any of the papers that you have filed with the Commissioner; isn't that true?
A. Unless it was included in our deposition of March 5th, we submitted some analyses -- they were, I believe, recorded as exhibits in that particular hearing.
Q. Now, doesn't this operating income actually reflect a much higher percentage growth year-to-year than you would have the Commissioner believe by looking at the materials that you submitted when you were talking about something like six percent to nine percent?
A. These are three years of growth, three years' worth of numbers; right?
Q. These are operating income for each of those years, and then LTIP targets for the corresponding three-year periods.
A. Right. Yeah, we had different numbers that we used for the years 2000 through 2002.
Q. Okay. Well, what were those numbers?
A. I would have to look at my report. They were -- I believe in 2000 they were higher than that in terms of actual results.
Q. Did you get these numbers from Premera?
A. We get them as reported from the AM Best. Why they are --

Q. So you are using -- instead of going to Premera, who you had available for you -- you chose to follow the AM Best numbers for whatever reasons they were reported the way they were?
A. Only to compare in a common reporting Premera to other companies.
Q. Wouldn't you agree it would be better to go to the direct source to find out what the actual operating income numbers are to confirm it before you made an accusation about Premera's performance?
A. Our purpose was to use a common database to compare performance across a number of beliefs. It could very well be other Blues had underreported results as well.
Q. It could be, but you don't know.
A. Right.
Q. All you know now is it is apparent that AM Best numbers, at least your interpretation of them, compared to the reality of what Premera's operating income is, are very different?
A. Yeah. I would have to have the opportunities to understand how those numbers reconcile.
Q. Okay. Well, you had months to ask Premera for its operating income before you made your report, didn't you?
A. Again, our purpose of using AM Best was to have a

common database to compare across all Blues.
Q. I understand that. But you started out with the assumption of AM Best that Premera wasn't doing very well, and these facts showed you just the opposite; isn't that true?
A. We were --
Q. You can answer that question yes or no, sir.
A. Well, on a relative basis. That's the only difference.
Q. Okay. Now, let's talk briefly about a minimum shareholder return, which I think was one of the other proposals that you raised for the LTIP for this one year after conversion.
You don't have any data in regard to Premera's peers that would indicate any minimum shareholder return related to the LTIP for those peers; isn't that true?
A. Premera's peers primarily use growth and earnings per share for their LTIPS.
Q. I understand. But that isn't the same as having a minimum shareholder return, is it?
A. It is a different measure than earnings per share.
Q. Right. It indicates that there has been -- some sort of improvement in the company; isn't that correct?
A. Both metrics could be accepted as that.
Q. So there is no particular reason why the

compensation committee should have the rigid requirement that you would have of some minimum shareholder return, rather than using their own best judgment for this one-year period to see what would best and appropriately motivate these executives to do a good job; isn't that true?
A. Just to clarify one point, the shareholder return metric would apply for a three-year period. So -- to clarify the point, for the plans granted during the restriction period, a minimum return metric would be applied.
Q. So you would require that, even though they were no longer getting cash for going over the stock options for the future -- isn't that true -- or stock awards?
A. They will receive both awards, both the LTIP and stock options. The LTIP is continuing.
Q. To get back to my question now that you have explained your position.
A. Right.
Q. There is no reason to think that Premera's compensation committee -- particularly when it has the addition of the designated foundation member -- would not be able to take into account your ideas, Towers Perrins' ideas or anyone else's ideas, and make a judgment as to how to best motivate these executives for

that one-year period; isn't that true?
A. We would clarify to -- shareholder return is not for a one-year period, it is for the period of time in which the plan was in operation.
Q. Even for that period of time, sir, there is no reason to think that the compensation committee, armed particularly with an additional member from the -- nominated by the Foundation shareholders, would not use its good judgment, taking into account a variety of measures, to determine what the best thing to do is for that one LTIP plan that covers three years?
A. We would expect the committee to act intelligently.
Q. Okay. They would also have the benefit of having outside consultants to talk to as well; isn't that correct?
A. That is correct. The shareholder return -- again, to repeat our rationale for that -- is that negates the debate about goal setting, internally-set goals.
Q. I have taken too much time, let me just cover one last point, if I may. That was your other proposal that you wanted to limit base salary. Now, first of all, you agree that the right way to decide salary is to determine the right salary by looking at the salaries of the peer group; isn't that true?
A. I would say the peer group of public companies, as

well as other survey databases of competitive companies in the health insurance industry.
Q. And you would certainly agree, as you testified back in March, it is not a common practice in ongoing companies to have any such salary-based caps; isn't that true?
A. It is implied versus explicit, yes.
Q. It is implied versus explicit? In other words, you look to the judgment of the compensation committee to do an appropriate control on salary increases? Is that what you are saying?
A. That is correct.
Q. Thank you. Now, I think you agree that people should be paid what they earn; is that correct?
A. I believe that was a statement in one of my depositions.
Q. And none of the peer groups have a salary limitation; isn't that true?
A. Other than that restriction under 162(m) if you want to -- you are correct.
Q. Thank you. And you did not analyze the salary growth for any of those Premera peer group members, did you?
A. We relied on other survey sources within the industry for that salary growth.

MR. KELLY: Very good. Thank you, sir. No further questions.

CROSS-EXAMINATION

BY MS. HAMBURGER:

Q. Good afternoon. I just have one question. In doing your work on this conversion, you didn't consider as part of your report the role that the addition of equity compensation may have played in the decision to convert?

A. We were not able to determine whether that was an incentive to convert or not. I could not come to that conclusion. Certainly, the opportunity to have a benefit like that would, of course, be a very powerful incentive to convert.

MS. HAMBURGER: Thank you.

REDIRECT EXAMINATION

BY MR. HAMJE.

Q. Mr. Nemerov, Mr. Kelly asked you some questions about the long-term incentive plan, the three-year plan, as it relates to the one-year restriction period. Do you recall that line of questioning?

A. Yes.

Q. Would you clarify what you said about the long-term incentive plan as it relates to the one-year restriction

period?
A. Yes. As I was saying, during the restriction period, due to the fact that Premera executive officers will not be receiving stock option awards for one year, we feel it is prudent for the long-term incentive plan during that time period to have some alignment to the shareholders.
And we believe having a minimum return goal attached to the long-term incentive plan that is started, commencing with the conversion, would be an appropriate way to link the executive officers of Premera with the shareholders. They don't have -- absent that, they have no one, other than prospectively post-restriction period there is no link at all. So that's the primary reason for that.
And secondarily, is -- as we phrased earlier -- our concern with the goal setting -- this presents a very objective, non-manipulatable metric set by the external market. It eliminates that concern.
Q. Mr. Nemerov, do you -- I am sorry -- do you recall your testimony in response to Mr. Kelly's questioning concerning the financial measures and how they might be -- how attainment of the financial measures may be -- or the compensation as a result of attaining the financial measures may be increased or reduced?

A. Yes.
Q. Does that apply to both the annual incentive plan, as well as, to the long-term incentive plan?
A. My understanding, from the plan documents, is that that is available under both programs.
Q. Do you cite some provisions relating to these matters in your responsive testimony?
A. I believe that was in my responsive testimony. Would you like the specific page?
MR. HAMJE: If I could approach the witness?
THE COURT: Yes.
MR. HAMJE: I am going to ask the witness to look at Exhibits S-66 and S-67.
Q. Mr. Nemerov, I have handed you a copy of S-66. Can you identify that, please?
A. S-66 is the 2002 Premera Blue Cross Officers' Annual Performance Incentive Compensation Plan.
Q. Is this the document you refer to in your prefiled responsive testimony?
A. Yes.
Q. And if you would take a look at S-67. Would you please identify that.
A. Premera Blue Cross Long-Term Performance Incentive Plan, 2002-2004 Performance Period.
Q. Did you also refer to this in your prefiled

responsive testimony?
A. Yes.
Q. Did Premera -- I am sorry, did Premera provide you with copies of these documents?
A. Yes, they did.
Q. Did you rely upon these documents in forming your -- coming to your findings with respect to the question of proving compensation or reducing compensation under these plans?
A. Yes.
MR. HAMJE: At this time the staff would move the admission of S-66 and S-67.
MR. KELLY: No problem. No objection.
THE COURT: Admitted.
Q. Would you briefly describe to the Commissioner how that particular incentive works under these particular documents.
A. If it is okay, it might be easier just to read the specific clause that you are referring to, or would you rather I just summarize it?
Q. I think you should probably summarize it.
A. Okay. Our interpretation of the plan, how they operate, is that an executive in office, a person who participates in this program, their award would be determined based on the company's financial performance.

So if a company is -- at an earlier example -- is at target, and an individual has an incentive opportunity -- let's say that's equal to 20 percent of their salary -- they would have a bonus calculated equal to 20 percent of their base salary.

The plan then provides for an adjustment of that award, plus or minus 20 percent, based on the evaluation of the performance against other -- as we call them -- non-financial performance objectives considered important.

So in that case, a person with a 20 percent bonus calculated based upon operating income would have a -- would have that award reduced by 20 percent or increased by 20 percent.

Q. Is this one of the areas about which you and Mr. Furniss have some disagreement?

A. We do.

Q. And it is one just of interpretation; is that correct?

A. I believe it is one interpretation. The materiality in our discussion relating to Furniss concluded that Premera has a more conservative plan than competitive practice, and we concluded with this provision that it is not more conservative in competitive practice. It is more, as we said earlier, it is atypical.

Q. In the grand scheme of things, is this a big issue with you?
A. No, it is not, per se, particularly with the annual incentive plan. It is more of an issue with the long-term incentive plan.
MR. HAMJE: That's all I have.
MR. KELLY: Questions?

RECROSS EXAMINATION

BY MR. KELLY:
Q. To your knowledge, is it not the actual practice in regard to the annual LTIPS in Premera that they have only used the additional non-financial performance requirements as a way of further reducing whatever other award would be granted?
A. We receive one year of data on the calculations, and in those cases the awards were reduced.
Q. So the only data you have indicates that the actual practice is a reduction?
A. For that particular year.
MR. KELLY: Okay. Thank you. Nothing further.

EXAMINATION

BY COMMISSIONER KREIDLER:

Q. Just a couple of questions that I was thinking about. One of them was PwC recommends that the compensation insurance last from three to five years, if I am not mistaken, that Premera had agreed to two years. Why does PwC recommend three to five?

A. I thought we had resolved that to agree with Premera.

Q. To the two years?

A. Right.

Q. The other is, is that -- and I was -- I had to go back to some of your testimony earlier, and I believe it was in connection to long-term incentive plans.

A. Right.

Q. And I believe you made a comment that -- relative to the goals, that I believe Premera was below minimum standards? Did I understand it correctly? Can you explain that to me?

A. They have set their performance minimums for their annual long-term incentive plans equal to approximately 50 percent of the budget or target that they set for the plan.

Normally, we see minimums set more in the range of 70 to 80 percent. The issue of a 50 percent minimum is -- while it is true that you don't accrue the full pay-out if you just get past minimum, you are much more assured of a pay-out than if you have a higher minimum set.

So the risk is, is the extent that the award opportunities are set, people could be receiving pay-outs for performance that may or may not be substantially better than the year before or the performance periods prior to that which the goals had been set for this period.

Q. I am curious, when you talked about compensation, whether it is direct or long term, I believe before your testimony had been described as below peer group, perhaps even described as conservative. And what you have said is that overall it was probably above the peer when measured against comparable not-for-profit Blues plans; is that correct?

A. That is correct.

Q. First you came up relative to AM Best numbers. It has always been my impression that companies relied very heavily on AM Best numbers because it obviously is a factor in judging how they are ranked in performance.

Is it, in your experience, that companies don't move aggressively if the wrong numbers are being used to correct those numbers?

A. I would think if there were egregious errors in reporting it would be discussed between AM Best and that company, because it affects the company's rating.

So our assumption was that, by using AM Best, we were using a reputable source that provides credible information, as reported consistently and accurately for all companies that provided information.

COMMISSIONER KREIDLER: Thank you, very much. I have no further questions.

REDIRECT EXAMINATION

BY MR. HAMJE:

Q. Mr. Nemerov, you indicated that you thought the three to five years, versus the two years under the assurances, had been resolved. Are you certain of that?

A. I am not certain. I have not been specifically involved in that particular discussion, which was why I may have misspoke, three to five years versus the two years on opposition assurances. I apologize if I -- that was one issue that I had not been in the middle of.

Q. Do you know who would be?

A. Would I know that there would be --

Q. Do you know who would be knowledgeable about that?

A. It could be one of the other PwC members or Blackstone or Cantilo & Bennett. I am sorry if I missed on that particular point, that was not one that I was in the middle of.

MR. HAMJE: That's all I have. Thank you.

MR. KELLY: Just a few quick questions as follow-up to the Commissioner's.

FURTHER RECROSS EXAMINATION

BY MR. KELLY:

Q. You talked about your assessments and where the targets were for LTIPS. In actual practice have these not been stretch targets for Premera each year?

A. Stretch targets?

Q. Yes.

A. My understanding is they have been submitted based on budget and forecast. So I don't know if I would consider those a stretch.

Q. When you talk about -- you use the term percentage, -- in fact, there is a dollar range around the target, not a percentage range; isn't that true?

A. But the minimum has been consistently with 50 percent of target.

Q. Now, when you say 50 percent of target, when you hit the minimum you don't get a hundred percent of your award, do you?

A. That is correct.

Q. You just get some award, isn't that true?
A. That is correct.
Q. And the -- and if you only get a small proportion of the full potential award when you hit the minimum, and then you don't do well on the other non-financial performances, those still are deducted against whatever amount you get for hitting even the minimum; isn't that true?
A. That could happen.
Q. Isn't that part of the plan if you -- bear with my hypothetical. If you only reach the minimum and you don't do well on your non-financial, then you are going to have a further docking of whatever award you are going to get; isn't that true?
A. That is true, under that hypothetical example, yes.
Q. And haven't the executives generally been able to -- because of the improvements in performance and non-performance measures -- been able to hit target rather than just hitting a minimum?
A. I believe that, for the years we studied, that the pay-outs have been above target consistently.
Q. So your concern about minimum -- the setting of a minimum is purely theoretical; is that correct?
A. No. I think it represents good practice.
Q. But has no practical effect over all the years that

you have studied; isn't that true?
A. For the years studied, it had no practical effect.
Q. One final point on AM Best numbers, they are used only for one part of Premera PVC and not for LifeWise or the other subsidiaries. Were you aware of that fact?
A. There is some adjustment of numbers, yes.
Q. My question was, were you aware of that fact or not?
A. Yes. There were some differences in reporting. Yes, I was aware of that.
Q. Okay. Did you not go back to Premera's data that they had given you to find out what their actual operating income was, company-wide, as opposed to just trying to make some adjustments on your own?
A. We would have to do that for every company, and AM Best peer group appears to be fair when comparing.
Q. Well, don't you at least want to start off on a solid basis to make sure you are comparing apples to apples, before you get started on this attack on Premera's performance?
A. We looked at four years of financial data across four different metrics.
Q. And if the other companies chose to report their entire company, as opposed to just one subsidiary, they would have a lot bigger number, wouldn't they?
A. And we looked at four different metrics --

Q. I understand. You are not responding --
A. -- in the last four years.
Q. Excuse me, sir, could you respond to my question. You don't know what the other companies were reporting, whether they were reporting all companies or subs or what; isn't that true?
A. It is what is reported.
Q. So the answer to my question is you don't know; isn't that true?
A. I don't know, but I don't feel it is material to our conclusion.
Q. I understand you don't. I just want to know what you know here. So you don't know whether you were comparing apples to oranges or grapes or bananas, do you?
A. What I know is we looked at four different metrics, over a four-year period, across almost 20 different companies. I am very comfortable with our conclusions on that matter.
Q. So your conclusions are comfortable in regard to -- at most, Premera Blue Cross, not for the rest of the company, isn't that true, if we didn't even report it to AM Best on the rest of the company; isn't that true?
A. That is true.
MR. KELLY: Thank you, sir.

THE COURT: Anything further from the Intervenors?

MR. HAMJE: I have a follow-up question with the Commissioner's questioning as well.

FURTHER REDIRECT EXAMINATION

BY MR. HAMJE:

Q. Mr. Nemerov, why do you recommend three years with regard to the compensation insurance?

MR. KELLY: I will object. The gentleman just thought that that had been resolved. There is no testimony --

THE COURT: Overruled. The question was about why he recommended, not why he recommends.

MR. KELLY: Okay.

THE WITNESS: I am sorry, could you repeat --

Q. Why did you recommend the three to five years?

A. I believe in our discussion, three to five years logically fit with the time period on the voting structure issues related to the conversion. That was the logic of the three to five years, to the best of my recollection.

Q. And in your work as an executive compensation consultant, do you rely on AM Best data on a regular basis?

A. Within the insurance industry, yes.

Q. Why is that?

A. Because it is one of the best, most available, most -- we believe -- most accurate sources of comparable information across a wide range of insurance companies.

Q. Is this something that -- are you aware of whether or not other executive compensation consultants rely upon it as well?

A. Sure. It is a database that's available to us for use in advising companies, and it is one source of information -- certainly, not the only source of information -- but it is one source that's considered credible.

MR. HAMJE: That's all I have. Thank you.

MR. KELLY: Nothing further.

THE COURT: Thank you. Please step down.

MR. HAMJE: Your Honor, at this time, if it is your pleasure, OIC staff would call Sandra Hunt to the stand.

SANDRA HUNT, having been first duly sworn by the Judge, testified as follows:

MR. HAMJE: Your Honor, may I approach the witness? I have got some booklets and I want to remove some things if I could.

THE COURT: Sure.

MR. HAMJE: Your Honor, I believe we have the original deposition here which I believe belongs to the Commissioner.

COMMISSIONER KREIDLER: Yes, it looks like mine.

DIRECT EXAMINATION

BY MR. HAMJE:

Q. Please state your name.

A. Sandra Hunt.

Q. Please state your position and your business address.

A. I am a principal in the Global Human Resource Solutions Division of PricewaterhouseCoopers. My business address is 199 Fremont Street, San Francisco, California.

Q. Could you describe a little bit about what your division does.

A. We provide consulting services around human resources, as well as related to health policy and health insurance operations.

Q. Please describe your educational and employment background.
A. I have a Bachelor's degree from Washington State University in Political Science, and a Master of Public Administration in public policy analysis from the University of Washington.
Q. And if you could talk a little bit about your employment background.
A. I was employed for three years at the Institute for Health Policy Studies at the University of California, San Francisco, doing health economics research. And in 1986, began employment at Coopers & Lybrand, which is a predecessor firm to PricewaterhouseCoopers. I am became a principal or partner at PricewaterhouseCoopers in 1996. I have been in the same division, performing health policy research, for that entire term.
Q. Who are your primary clients?
A. Most of my clients are state governments. I work with a number of states in the area of health policy and health insurance reform, as well as, working with states on their low income population programs. I also work with employers and with insurance companies around the cost of health insurance and how it is marketed and delivered.
Q. Would you generally describe the purpose of your

testimony today.
A. Yes. I led the team that performed the market impact analysis of the likely effect of the proposed conversion of Premera Blue Cross. I worked with a large team -- including actuaries, economists, health policy researchers -- to assess the particular circumstances in Washington, the health insurance markets, and to draw conclusions about the likely effects of the proposed conversion.
Q. Will you be the only member of the PwC team that will be talking about the issues that will be the subject of your testimony today?
A. No. I will be followed by Marty Staehlin, an actuary, who will discuss many of the actuarial components of our analysis, and by Ed Gold who will discuss the economic -- the specific economic modeling that we performed as part of our analysis.
Q. Have you submitted any expert reports in this proceeding?
A. Yes, I have. We prepared a report -- I am afraid I don't have all the specific titles memorized -- here it is. The Economic Impact Analysis of the post-converstion of Premera Blue Cross for the State of Washington, dated October 27th of 2003, and the Economic Impact Analysis of the Proposed Conversion of Premera

Blue Cross for the State of Washington, Report Addendum, dated February 27th, 2004.

Q. Did you also submit prefiled testimony in this matter?

A. Yes, I did. I submitted both direct and responsive testimony.

Q. At this time, do you adopt your prefiled testimony and your reports?

A. Yes, I do.

MR. HAMJE: Commissioner, at this time, the staff would offer into evidence the following exhibits: S-19, which is Ms. Hunt's curriculum vitae. S-20, which is the Economic Impact Analysis of the Post-Conversion of Premera Blue Cross for the State of Washington, dated October 27, 2003. S-21, which is the Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington, Report Addendum, dated February 27th, 2004. S-47, which is the prefiled direct testimony of Ms. Hunt. And S-48, which is the prefiled responsive testimony of Ms. Hunt.

THE COURT: Any objection?

MR. KELLY: No objection.

MS. HAMBURGER: No objection.

THE COURT: Admitted.

BY MR. HAMJE:

Q. Ms. Hunt, please describe how you -- please describe your experience regarding the kind of analysis for which PricewaterhouseCoopers was engaged.

A. We performed analyses in approximately 15 states of the impact of various health insurance reform proposals. I also led the team that performed the market impact analysis of the proposed sponsor demutualization of Kansas Blue Cross, when Anthem was proposing to purchase that plan.

Q. Would you please describe how you conducted your analysis.

A. We conducted our analysis through several approaches. We gathered a wide variety of information on the structure of the health insurance market in the state of Washington, including the particular presence of health plans, where they operate, who they sell to.

We held a number of conversations with OIC staff, with Premera, with brokers, providers, other health insurers, to get a good understanding of current operations.

We looked at other Blue Cross/Blue Shield conversions to understand what has happened in those particular circumstances. Then we examined the various models on financial projections that Premera presented to us, and using that broad variety of information, reached conclusions.

I am sorry, we also looked at, specifically, the regulatory structure in the state of Washington and how the regulations around pricing insurance products would play into the likely outcomes of the conversion.

Q. What information did you rely upon in your analysis?

A. We relied on information from the OIC on annual filings, on rate filings. We relied on the information provided to us by Premera, specifically as regards to their rate filings, their financial projections, and the information we obtained from other players in the market around Premera's current performance and issues or items that they wanted to bring to our attention about their understandings of the operations.

Q. Can you tell us what you assessed?

A. Well, we assessed the structure of the market. We assessed where Premera has a significant presence in the market, where other health plans have a significant presence. Where plans have entered markets and gone back out again or left the markets. The premium rates, earnings levels, a wide variety of statistical measures, to understand how things have changed over time and how they might be expected to change in the future.

Q. Did you look at variations in geography and how healthcare is financed?

A. We very specifically addressed the question of how -- or what products are available differently, by geography. And, specifically, the fact that in eastern Washington Premera has a very large presence that it has maintained for many, many years, despite the fact that other health plans have come into the market and worked to gain market share in that area.

We looked at differences in performance as it relates to group size, between administrative services contracts, large groups, small unregulated groups, small regulated groups and individuals. As well as, public -- individuals who are covered by public programs, such as Medicaid and Medicare, because those are all different ways in which health insurance is purchased and typically have a different pattern in terms of who provides coverage to those populations and how purchasing decisions are made.

Q. Did you also assess Premera's expectations for growth?

A. We did. We looked at Premera's expectations for growth, and that was part of the financial projection model that we relied upon in our analysis they provided us in the Form A filing. And then later in the planning model, information on expected changes in numbers of individuals who would be covered, and where --

specifically where changes might be expected between insured and administrative services contracts.

Q. Did you also assess Premera's allocation methods -- allocation of costs methods?

A. We did. That is an area that Marty Staehlin will be discussing in some detail later.

Q. Did you also assess behavior and performance of for-profit, as well as not-for-profit health plans?

A. We did look at statistics on net operating margins for for-profit and not-for-profit health plans, and looked at the literature that has been developing around differences in performance for plans of different ownership structures.

Q. Did you assess operating margins?

A. Yes. Operating margins were a substantive part of our analysis. Specifically, looking at Premera's current levels of operating margins, and those of the best performing for-profit plans, to understand where Premera is relative to those plans that are considered -- at least in our consultations with investment bankers -- around the levels that can be achieved.

Q. Did you also assess where changes might be or could be expected to occur if results of operating margins and other performance measures were approved?

A. Yes, we did. That is an area that Ed Gold will be speaking to. Our general conclusions were that there are some areas of the state where Premera has a very large and dominant market share. And that to the extent that improvements in operating margins are needed, those improvements would be isolated to eastern Washington in the individual and small group markets.

Q. For a moment now, if I could turn to your key findings.

MR. KELLY: May I Voir Dire, please?

MR. HAMJE: Pardon me?

MR. KELLY: May I Voir Dire the witness?

MR. HAMJE: Certainly.

VOIR DIRE EXAMINATION

BY MR. KELLY:

Q. Are you only going to be testifying to the key findings that you made, as opposed to the key findings made by Mr. Staehlin or Mr. Gold, is that the case?

A. The key findings of our team will be discussed. And then our other witnesses will provide the detail on how those were arrived at.

MR. KELLY: I think the witness has made it clear that she only wrote certain portions of the report, and others have expertise and actuarial --

supposedly econometric areas, and I would object to her testifying. If they are going to be here tomorrow, they should testify about their findings.

MR. HAMJE: Your Honor, as the team leader of this group and as a principal author of the reports, Ms. Hunt is intimately aware of and understands the key findings and can at least articulate them so that it can kind of be a preview of what we are going to be discussing with the next couple of witnesses.

She will not be able to go into detail about them, because she is not an expert, and she is not an economist, nor is she an actuary. But at least she can articulate them so we can have them out, and we can go ahead and follow up with the other witnesses.

THE COURT: She can give us a framework perhaps, and then the details can come from other witnesses. We don't want her to repeat testimony that would be better focused with the next witness. Go ahead, please.

DIRECT EXAMINATION (Continued)

BY MR. HAMJE:

Q. So my question is -- I wanted to turn to the key findings, and I think I would like to start with what you found about -- specifically, that makes Washington

unique?
A. I won't say unique, but I will say the particular circumstances that we thought important for consideration.
The first was we looked at the demographic characteristics of the state, including things like income level, numbers of uninsured or percent uninsured, unemployment levels, and as that relates to health insurance coverage and changes in health insurance coverage.
It is our belief that there is limited opportunity for growth in sales of new insurance to additional people, with the exception of growth that relates from natural population growth in the state.
Q. Does Premera operate in a number of different markets--
A. That's --
Q. -- in Washington?
A. One of the most important conclusions that we reached is that Washington has multiple insurance markets. The most important differences are by geography and by group size. There is clearly a difference in how insurance is sold or who sells insurance in the eastern part of the state and the western part of the state.

And as regards Premera's particular market share, that can be described or is very much influenced by the locations where Premera holds both the Blue Cross and Blue Shield mark. Regence holds the mark for the Blue Shield part of the business in the west and in some counties in the east, and you see some distinct differences in penetration rates based on where that mark is held.

The specific maps that describe those circumstances are in our report, in Chapters 5 and 9, if would you like to review those.

There is also distinct differences by group size. When you look at the level of penetration of Premera for large groups in the west, they are the second largest insurance carrier. Regence is the top one.

When you look in individual products, they are the largest across the state, but very much so in the eastern part of the state, where I believe the penetration rate is something around 84 percent, even including those counties where Regence holds the service mark in some of the counties.

Q. Did you also make some findings with respect to individual and small group?

A. Yes, I think I discussed those.

Q. And then were there any findings with respect to

potential for Premera in facing different incentives?
A. Yes. We did look at the literature and our observations on insurance carriers once they become for-profit.
We believe, actually, that Premera has behaved similar to a for-profit for the last few years, likely in a buildup to this proposed conversion. But post-conversion health plans have a different set of incentives. And they may be a marginal difference, but there is a need to perform at a maximum level, and it puts added emphasis on short-term performance.
Q. Did you make any findings with respect to the challenges that Premera may face as a for-profit plan?
A. Again, our conclusion was that Premera will be faced with a tension of maximizing the stock value for the benefit of its stockholders, including the Foundation, and maintaining or containing premium rates and provider payments.
So because they will have higher levels of expectations regarding performance, that tension will be present and they will need to respond to that.
Q. Were there any findings with respect to the administrative services contracts?
A. We looked at the difference between the fully-allocated costs for product lines and the pricing

by product line. And what we found was that Premera has made a business decision to partially subsidize its administrative services contracts. Our understanding is that the way those contracts are priced is to cover their marginal cost -- which means the additional cost that is created by selling one more policy -- and a portion of their fixed cost -- which would be the general overhead, executive salaries, buildings, and so forth -- but not the fully-allocated amount of those costs.

That's a strategy that can be helpful in building market share in that area. But when we look at Premera's growth goals, we see that their expectations are, from their Form A filing, that they will grow -- between 2003 and 2006 -- approximately seven percent in their insured products, over that time period, in the state of Washington, and approximately 30 percent in their administrative services contracts.

So our concern is that, over time, putting this together, that more of the fixed costs would need to be covered by the administrative services contract pricing, and that may dampen their ability to meet their growth goals.

Q. Would you please compare and contrast the difference between marginal costs and fixed costs.

A. The marginal costs are the additional costs that are created when more -- an additional premium is sold. So you need more people to answer phones, you need more people to do customer service, because you are selling to more people.

Fixed costs would be the overhead, the executive salaries, other things that don't change as a consequence of serving more members.

Q. Did you also make some findings with respect to the regulatory environment here in Washington?

A. We did. That is an area that Marty Staehlin will talk about in some detail. Very briefly, the conclusion was that the structure of the regulations, because of the particular pricing models, allows for some variation in pricing by geography. And that, consequently, there is some opportunity to change the structure of premiums for particular products.

That becomes important in the types of products that are being sold today. Premera's Dimensions product, for example, is a very complex product that allows for a wide amount of variation in the structure, and consequently can allow for some changes in how premium rates are developed.

Q. Do your findings -- do you also include a finding with respect to charging different rates between eastern

Washington and western Washington?
A. We do. And that is, again, an area that both Marty and Ed will be testifying to in much more detail.
What we looked at was the areas of the state where it appeared Premera has the ability to specifically influence the market. And taking the premium rating structure into account, the amount of change in premiums would likely be required to meet the operating margin goals that Premera has in its models with some slight adjustments in certain market areas.
Q. As part of your findings, did you develop any estimates with respect to any amounts that would be involved?
A. We did. We estimated that there could be premium rate increases of as much as eight to ten percent in the individual products, in eastern Washington -- again, in those counties where Premera has a substantive market share -- and of two to four percent in the small group products.
Q. Did you make any findings with respect to the cost allocation model?
A. The findings related to the cost allocation model are, again, an area that Marty will testify to in more detail. The general findings were that, over time, Premera has not had a specific need to allocate all

costs to all product lines in a way that absolutely reflects the costs of each of those product lines.

There is two issues that arise from that. One is, as they would become a public company, understanding what your costs are in each of your product lines becomes more important, but it also goes to the allocation question when we are trying to understand the historic distribution of cost between the two states and how that -- those calculations should be made.

Q. Did you also develop any findings with respect to entry and exit into the marketplace in eastern Washington?

A. We did. If I could, I would like to refer to my responsive testimony, where we prepared a chart related to those -- to the entry and exit of --

Q. That would be S-48; is that correct? It should be in front of you.

A. Page four, to be specific. What we have shown in this chart is -- we have taken from the report of NERA -- Tom McCarthy, who testified a few days ago -- information that was presented in their report, and then provided a description of what has actually -- what each of the plans that are referenced in that report actually are doing today or the circumstances of that entry.

What we see is that a number of plans have entered eastern Washington, but that they have minimal enrollment or they have exited the market again.

So the issue at hand, as we were looking at this question is whether other plans productively enter the market and can remain and become a significant player. And we are looking for performance around, specifically, the individual and small group markets, where we have a concern that the products or the prices could change under the circumstances.

Q. Did you also make any findings with respect to the economic assurances presented by Premera?

A. Yes. We worked -- along with the rest of the entire consulting team -- with Premera and its staff over the period of time from November to just up until the revised Form A filing.

As part of that process, we discussed with them our particular concerns around potential changes in premium rates for specific calculation groups and worked with them to construct assurances to address those issues.

We believe that we reached some good conclusions with them on assurances that the methodologies that would be used to develop premium rates would be maintained for the period of the assurances, that methodologies for reimbursing Premera's brokers and managers would not be structured in a manner that would provide incentives to differentially market to western Washington versus eastern Washington, or to basically change how insurance is sold today. And to ensure that the existing methods for determining network adequacy would be retained.

We think that those assurances are good and helpful. We don't think they eliminate all of our concerns, but we do think that they mitigate them.

But we think that they are too short. Premera has offered a term of two years. We believe that it will take longer than that for the OIC staff to have a good understanding of what exactly is happening in those rate filings, and in the -- the whole structure of how Premera is selling its insurance in those areas, and we have recommended a period of three years for the assurances.

Q. Has Premera agreed to provide a bring-down opinion?

A. Premera did include in its plan of conversion a bring-down certificate -- again, a document that we discussed in our meetings with Premera during that time period.

The information that will be provided to the Commissioner in the bring-down process will, in essence, provide a benchmark against which future performance will be measured.

The -- what Premera has currently offered in its bring-down certificate, we believe, is far too broad. It includes both Alaska and Washington together in some of the measures of market share, it includes all of the state of Washington without differentiation between eastern and western Washington, and it does not specifically distinguish by group size. So we don't think it gives enough information to provide benchmarks for future monitoring.

Q. Are the reporting requirements set out under the assurances more than what would be ordinarily required of a company such as Premera under Washington law?

A. Yes, they are. As part of the economic assurances, because under the existing individual group regulation -- or individual product regulations, very little information goes directly to the OIC, and the level of review for individual products is very different and less intensive than it is for a small group. In those assurances, Premera has agreed to provide similar reporting for those products.

Q. I believe we have covered all of your key findings. Can you think of any that I might have omitted in asking you about?

A. Let me just take a very quick look at my notes. I think that is --

MR. HAMJE: That's all we have for this witness at this time. Thank you.

CROSS-EXAMINATION

BY MR. KELLY:

Q. Good afternoon, Ms. Hunt. You are the project director for the entire PwC team, not only Staehlin and Gold, but all the others who testified here today; is that correct?

A. At least the person who tries to hurt cats.

Q. Okay. Now, the PwC report, the one that you prepared -- I guess we call it the Economic Impact Report -- contains a lot of descriptive information about Premera, Washington state, its employment and unemployment regulations, networks, lines of business and so forth, does it not?

A. Yes, it does.

Q. And several times during your testimony this afternoon you talked about the detailed background, sort of descriptions of what you had done and what existed, descriptions of what historically has happened around the state, and so forth; is that not correct?

A. I think that's correct.

Q. Okay. Did you draft most of those descriptions?

A. A staff person drafted a good portion of the report

for my review.
Q. Now, is it your testimony that you need to get a separate license for each county in which you do business as an insurance company in the state of Washington?
A. I don't believe I said that.
Q. You don't remember saying that in your deposition?
A. I don't recall.
Q. Well, because of the time shortage, maybe you could look at your deposition over the break.
And you were the editor -- I guess, in addition to corralling the descriptive information -- of this Economic Impact Report and the other reports as well; isn't that true?
A. I was specifically the editor of this report. I was not the editor of some of the others.
Q. I see. Did you try to edit any of the others?
A. I believe that I reviewed many of them. Some of them I edited for clarity, others I did not have particular comments on.
Q. Okay. And you are not a tax lawyer or a tax accountant, so you couldn't do much substantively with the tax reports, I assume?
A. That's correct.
Q. In your deposition I think you described your role

this way, and just let me ask you if that's correct. "My role was to ensure that I understood the analysis that was done, and why the numbers were what they were, and I did a lot of word-smithing of the reports;" is that correct?
A. That sounds familiar.
Q. Now, you don't claim to be an expert in economics or econometrics, do you?
A. I am not a Ph.D. economist, no.
Q. And your testimony in your deposition was -- when I asked you that question, you claimed to be an expert in economic or econometrics, your answer was no; is that correct?
A. That's what is in the deposition I believe.
Q. And you were under oath when you gave that deposition and you testified accurately, didn't you?
A. Yes, I did.
Q. You are not a CPA either, are you?
A. Nope.
Q. Nor are you a cost accountant?
A. Nope.
Q. For that matter, Mr. Staehlin is not a CPA or a cost accountant either, is he?
A. He is not.
Q. And you don't claim to be an expert in actuarial

matters, do you?
A. I spend a good portion of my life working with actuarial matters, but I am not a certified actuary.
Q. And when I asked you whether you claimed to be an expert in actuarial matters in your deposition, you said no; isn't that correct?
A. I don't recall the exact wording.
Q. Now, Ed Gold was the person who did the econometric model; is that right?
A. That's correct.
Q. And he is not a healthcare expert; correct?
A. I don't believe he specializes in healthcare. I think he is a more general economist.
Q. When I asked you the question was he a health expert in your deposition you said he wasn't; isn't that true?
A. Probably.
Q. Now, he needed help understanding the factors involved in analyzing the issue of competition in eastern Washington; isn't that the case?
A. He did consult with the other members of our team to understand how health insurance is sold, yes.
Q. Yes. And he needed help in understanding the factors involved in analyzing the issues in eastern Washington; isn't that true?
A. I think I just said yes.

Q. And you certainly said yes now; isn't that right?
A. That's what I heard.
Q. Now, Mr. Gold didn't give you guidance about what economists consider barriers to entry, you gave him that information; isn't that true?
A. I think that was -- it depends on the context in which you place that statement.
Q. Well, I asked you the question whether you gave -- who gave who guidance, and you told me in your deposition that you gave him guidance and not the other way around; isn't that true?
A. Well, I think in certain areas Mr. Gold would be most qualified to discuss the theoretical construct of barriers to entry as it relates to health insurance. I probably helped him to understand those issues.
Q. He wouldn't understand barriers to entries in health insurance, he is not a health insurance economist, is he?
A. That is not his specialty, no.
Q. So -- okay. While I am thinking of it, are you familiar with the publication called Health Leaders Research?
A. Yes.
Q. Okay. Is that the type of publication that is used to provide information and data for the healthcare

community?
A. Yes.
Q. Okay. Now, just -- I think you mentioned this briefly in your direct, you and other members of the PwC team -- and others as well, other consultants -- met on a number of occasions with Premera; isn't that the case?
A. Yes, we did.
Q. And you had long sessions where you would talk with them and try and find out how things would operate and ask them for data and so forth; is that correct?
A. That's correct.
Q. Now, I wanted to ask you about some things that occurred in the course of the work that you did in preparing your reports. You actually had a lot of meetings and you took notes at the meetings, did you not?
A. Yes.
Q. Okay. And luckily you have very legible handwriting, as I learned in taking your deposition. Could you turn to Exhibit P-167, please.
A. Is that here somewhere?
Q. No. I believe Mr. Hamje, as has been our pattern here, will get a copy for you.
MR. HAMJE: We have only one copy of our own. Could we use another one -- borrow one from the

Commissioner's staff? Is that all right?
MR. KELLY: As long as we have one for the witness and one for you, it is okay with everyone else.
BY MR. KELLY:
Q. While we are waiting for everyone to get their copies, let me ask you a preliminary question. I am going to refer to two short sections of this so you don't have to read it all.
We were able to obtain these notes in the course of discovery in this case; is that right?
A. I assume that's right.
Q. Okay. Does everyone have a copy of 167 who needs to have it? Good. And all I want to do is turn you to the third page, which the last Bates number is 57. And up at the top, this is your handwriting and I believe it is T/C, telephone conference, December 4th, 2002, a long time ago.
A. I am sorry. I am not sure that I am on the right page.
Q. 167, the third page in, and at the top it should say telephone conference 4/02.
A. 4/02?
Q. 12/4/02 is the telephone conference.
A. Yes.
Q. Okay.

A. Got it.
Q. Premera conference. About halfway down there is actually a little box you have there, and it reads, "Keeping notes confidential. Just notes" -- "just note at beginning of notes send only to C & B."
Now, who is C & B, you are referring to?
A. Cantilo & Bennett.
Q. If you turn now to the fourth page and last page of this exhibit, this is -- apparently, you are in the same phone conversation, and the entry I am interested in is the first two lines, "Rusty Fallis, why a false deadline? Jim O -- PR issue."
My question to you is, is the Jim O that is being referred to there Mr. Odiorne?
A. Yes, it is. I would be happy to provide some more context for these notes if you would like.
Q. Because we are all on a clock, Mr. Hamje will have to use his time for that. I just wanted to know who Jim O was for sure. That's all I have on that exhibit.
I wanted to go on to another situation that occurred during the course of your work, and that is that you, the PwC team, economic impact team, early on were having a lot of trouble with this model that you were trying to develop, isn't that the case?
A. I don't think that's an accurate description.

Q. Okay. Well, isn't it fair to say that you have come up with some very unusual results from the model in terms of percentages that western Washington would have if one is to believe what your model predicts about eastern Washington and its impact on western Washington?

A. I don't believe that that's correct.

Q. Well, we will get into that a little later. Okay, now, if you would turn your attention -- I hope it is in the same book --

MR. KELLY: I am going to move to admit 167 -- or at least the two entries that I read into the record.

MR. HAMJE: Are you saying just --

MR. KELLY: I would like to move to admit the whole thing and I will so do.

MR. HAMJE: No objection.

MS. HAMBURGER: No objection.

JUDGE FINKLE: Admitted.

BY MR. KELLY:

Q. Okay. Now, if you would turn to 165 please. This is some more of your -- Exhibit P-165. I am not sure whose handwriting -- is that your handwriting on the first page?

A. Yes.

Q. Okay. Well, luckily we are not asking about it and

going on to the second and third and fourth pages. So this is a -- notes of a phone conversation on page two that you had on June 6th, 2003, Keith Leffler, John Ellis, and etcetera; is that correct?
A. It appears to be.
Q. And over in the left-hand side you see the name Keith Leffler; is that correct?
A. Yes.
Q. Okay. And then what I am interested in is if you would read into the record on the right-hand side of that arrow, I guess -- whatever it is -- it starts out, "Have no market power." Would you read that into the record, please.
A. It says, "Have no market power either for regulatory or market reasons."
Q. And you were taking your notes about what you were hearing from Keith Leffler on June 6th, 2003; isn't that correct?
A. That may be correct. It may be in a different context. It may have been discussing other issues. I don't know that there is enough information here to --
Q. So all that we know is what is left behind in your notes; isn't that correct?
A. That's all that's here, yes.
Q. Okay. Now, if you go two pages further on to June

2nd, '03. Do you see that?
A. Yes, I do.
Q. Okay. And halfway down, we're interested in the Keith Leffler entry, and would you read starting with "market power," please.
A. It says, "Market power only is insufficient. Second player can expand fast enough if conditions are right."
Q. And that's information you heard from Mr. Leffler way back on June 2nd, 2003; is that correct?
A. I am not sure if that's what that means, meaning that we were going to follow up with him on that question, I don't recall.
Q. So all we have is the record of what you wrote at that time; is that correct?
A. These are the words that are on paper.
MR. KELLY: I will move to admit Exhibit 165.
MR. HAMJE: No objection.
MS. HAMBURGER: Your Honor, I object as to the relevance of both this and the previous one. It is unclear what the relevance are of these notes when -- I object to the relevance. It is unclear what the relevance is of these notes when the witness has testified that she doesn't recall the purpose or meaning behind the notes that were written.

THE COURT: Admitted.

BY MR. KELLY:

Q. Now, if you would turn to Exhibit -- I am sorry. Now, I would like to shift your attention to early October, 2003. And you did not see a draft of Dr. Leffler's report until it was sent over to the OIC; is that correct?

A. Yes.

Q. Okay. Yes, it is correct. It was a poorly-worded question, I guess. Could you turn your attention to Exhibit 161. This is an e-mail string. Let's read from the bottom up. That starts with John Hamje, sending to Andrew Taktajian, a copy of Leffler's report; is that correct?

A. Yes.

Q. And that was at 2:27 p.m. then on October 7th?

A. I think it was October 3rd.

Q. I am sorry, October 3rd.

A. To clarify.

Q. Then Andrew sent a copy to your assistant, Susan Maerki; is that correct?

A. Yes, my colleague.

Q. And then Susan sent a copy to you and also sent it on to Ed, that would be Ed Gold, and Raman, who is an assistant, I believe, to Mr. Gold?

A. Yes.
Q. And there you are being asked -- or it is being said -- "Request your assistance with the review of Leffler's report. Premera notified Cantilo & Bennett that they found inconsistencies between our reports." Is that what it says?
A. I need to find the precise part of the page.
Q. It is towards the bottom of the first page, I am sorry. Right below Ed and Raman.
A. Yes.
Q. And, of course, Ed writes back and says, well, they really aren't that inconsistent; is that correct?
A. Yes.
Q. But it was a matter of concern for you, was it not?
A. Yes, it was.
Q. Okay. There is nothing worse than inconsistencies, is there? Or little worse?
A. There is probably a lot worse but --
MR. KELLY: I will move to admit P-161.
MR. HAMJE: No objection.
THE COURT: Excuse me, I need to hear.
MS. HAMBURGER: No objection.
THE COURT: Admitted.
MR. KELLY: Thank you.
Q. Let's turn to P-166. That's a -- do you have it in

front of you there?
A. Yes, I do.
Q. That's an e-mail that Susan Maerki sent out, later that day, after you got the report, with highlights in regard to Mr. Leffler's report; isn't that correct?
A. It appears to be.
MR. KELLY: Okay. I Will move to admit that exhibit as well, 166.
THE COURT: Hearing no objection, admitted.
MR. HAMJE: No objection.
Q. Now, you and Susan Maerki and Ed Gold and Marty Staehlin met -- or had a phone conversation, I can't recall which -- with Mr. Leffler about his draft report, did you not?
A. Yes, we did.
Q. Okay. And you -- that being PwC -- made proposals for changes in Dr. Leffler's report; isn't that true?
A. We discussed the issues where we thought there were uncertainties, and clarified some issues for him, and he made changes in his report.
Q. Okay. Well, let me read to you an excerpt from Dr. Leffler's deposition in which he describes the meeting, and I will ask you if that accurately reflects your recollection of the meeting, in a question and answer format.

"Q. And these changes are as a result of some proposals that PwC has made?

"A. Proposals in the sense of proposals to me. I don't mean yes -- yes.

"Q. And this was after the -- between the preliminary report and the final report?

"A. Yes."

Q. Is that the way you recall things going?

A. Yes.

MR. HAMJE: May I have the page and line number that counsel is referring to, please.

MR. KELLY: I think it is at page -- it is page 144, line 22, up through 145, line 3.

MR. HAMJE: Thank you.

MR. KELLY: You are welcome.

Q. Okay. Now, other changes were made to these reports through the influence of different people; isn't that true?

A. Yes?

Q. Okay. Could you take a look at Exhibit P-168. This is an e-mail, e-mail string, that is between and among Mr. Taktajian and your group; is that correct?

A. Yes.

Q. And at the bottom of page one, under number 1, footnote 8, he has asked for a change, and Mr. Taktajian

says, quote, "It is a minor point, but trust me, make the change," end quote. Am I reading that correctly?
A. Yes.
Q. And you trusted him and you made the change; isn't that true?
A. That's correct.
MR. KELLY: Move to admit Exhibit 168.
MR. HAMJE: No objection.
MR. KELLY: I want to get to --
THE COURT: Admitted.
MR. KELLY: Sorry.
Q. I want to get to one other area before we wrap up this afternoon. And you have a theory, as I understand it, that even if Premera had good net income and good growth prospects, there would be pressure on them from Wall Street to improve their margins; isn't that true?
A. Yes.
Q. Now, you are also not an investment banker; isn't that true?
A. That's correct.
Q. And did you not assert in your report, S-20 -- which I guess was your first report -- the following: Quote, "Additionally, high-performing stock companies consistently meet net operating margin goals in all lines of business;" is that correct?

A. That was in our original report, yes.
Q. Okay. And that relates to this question of high performance, whether Premera is going to be able, in your view, to meet high net operating margins; correct?
A. Yes.
Q. Now, you are not aware of any public company that reports results by line of business or that reports target margins, are you?
A. Not in their financial statements, no.
Q. And would you agree that net income is important when assessing the performance of a company?
A. Yes.
Q. Would you agree that growth prospects is also important in assessing the performance of a company, such as might be done by investment brokers or Wall Street or even lowly investors like you and me?
A. Yes.
Q. But you don't say anything about net income in your report talking about the pressures that are going to fall upon Premera because someone is going to be looking at their net operating margin, do you?
A. I don't believe so.
Q. Okay. Now, Goldman Sachs told you that margins were less important than the other two measures of increases in operating income and growth prospects; isn't that

true?
A. I don't recall any conversations with Goldman Sachs.
Q. Okay. Because of the time I am going to come back to this tomorrow morning, but it is page 209 in your dep that we will be looking at in that.
Let me ask you this, didn't Blackstone also tell you that margins were less important than operating income and growth for prospects?
A. They did tell us that the other characteristics were important.
Q. Okay. But despite having been told by two premiere investment banking firms -- Goldman Sachs, if I am correct in my reading of your deposition, and Blackstone -- you didn't put that in your report, did you?
A. It is not in our report, no.
Q. If Premera does well with its net income and if it has good growth prospects, there wouldn't be any particular pressure on Premera to improve its operating margin, would there?
A. I would disagree with that.
Q. Okay. Didn't you agree with me that that would certainly be a possibility when I took your deposition some months ago?
A. I haven't reviewed that part of the deposition

recently. I don't recall.

Q. It is page 207. You can look at it tomorrow. Well, let me ask you this, to present a full and fair picture to the Commissioner, shouldn't you and PwC have included that discussion from Blackstone and others, including Goldman Sachs, regarding net income and operating income -- I am sorry, and growth prospects in your report to the Commissioner?

A. We don't believe that there is any unfairness in the report. There is perhaps additional information that could be brought out as well.

Q. When I was asking you that very same question you said you decided not to do it; isn't that true?

A. That may be what I said.

Q. Well, speaking of high performance and pressures that may or may not arise, do you think that your efforts to put in a certain aspect of Premera's economic condition, which might not be as good as its other aspects, might have resulted because you wanted to show something for the money that had been spent on your work and PwC's work as a consultant?

A. I am sorry, I am not sure exactly what you are trying to get at.

Q. Let me be more direct. To date, PwC has billed 4.81 million dollars for its work; isn't that true?

A. I believe that's approximately.
Q. If you didn't have anything to show, if your model didn't work, if there wasn't any market power, how could you justify having spent all that money?
A. The money was spent performing the analysis. The outcome was not known until we completed the work.
Q. You certainly knew that the Commissioner, unless it was brought out in testimony today, would never know that you had been told that two investment bankers said there isn't that much to worry about in operating income; isn't that true?
A. I think we always understood there would be a thorough review process.

MR. KELLY: Well, thank you. I have no further questions -- I am sorry, I do have further questions, but I am onto another section and would like to take a break at this point.

THE COURT: Before we conclude, can I have a reality check here on where OIC's testimony stands?

MR. HAMJE: Yes. I guess we -- tomorrow I assume Ms. Hunt's -- her testimony will be completed tomorrow. Dr. Leffler is only available tomorrow. So we would need to probably take him immediately after Ms. Hunt is completed.

And then we have Mr. Staehlin, Mr. --

Dr. Gold. And we have Lichiou Lee and Patrick Cantilo. And, of course, the -- we have been notified by Mr. Coopersmith that he would like to take a witness out of order tomorrow afternoon, one of his witnesses. We have also been notified by Mr. Madden that he would like to take a witness out of order sometime tomorrow morning, a telephone witness.

MS. HAMBURGER: I am sorry, I just -- I didn't mean to interrupt you, but I just wanted to correct you that's Friday morning for Mr. Madden's witness.

MR. HAMJE: Friday morning then. Then I understand Mr. Coopersmith has indicated he would like to take another one of his witnesses out of order on Friday afternoon.

MR. KELLY: All of those are fine with us. We would be happy to accommodate the witnesses.

THE COURT: About how much longer do we expect on Ms. Hunt?

MR. KELLY: I think I will take about 15 minutes.

THE WITNESS: I would be willing to stay the night if you want to wrap things up.

THE COURT: I think -- it is not in the cards with the Redirect. I am just concerned that with

Mr. Coopersmith's witness and Mr. Leffler, perhaps being a long witness, are we in good shape if we resume Ms. Hunt in the morning?

MR. HAMJE: Well, if Ms. Hunt only has 15 minutes Cross-Examination remaining, I don't anticipate that our -- I can't really -- I don't know what the Cross will consist of tomorrow, but I would think that maybe we could be finished within an hour or so with her testimony if there is only 15 minutes more of Cross.

MR. KELLY: Well, I probably should have explained, it is 15 minutes of Cross, after I have time to go home tonight and pair it down. I think it would be more efficient to jump in on this, maybe even start early tomorrow morning.

THE COURT: As long as you are reasonably confident we have time to do what's on the plate for tomorrow, that's the basis of my question.

MR. KELLY: It seems to me we have to get on Dr. Leffler and Dr. Collins. We will certainly be finished with Ms. Hunt early enough. And unless those witnesses are going to take all day, we should be able to do that easily.

MR. HAMJE: I would think we might even -- depending on how long Dr. Leffler is on the stand, we might even be able to sneak in another witness somewhere in there.

THE COURT: A separate question, you received -- I hope, but perhaps not digested -- the ADI allocation comments. I don't know if you have any intent or wish to present any testimony from witnesses who have already testified related to the matters raised in ADI court.

You don't need to take a position on this instantly, you can telling me in the morning. But we need to sort out what, if any, impact that has on the evidence in this hearing.

MR. HAMJE: It is difficult for me to respond because I haven't seen this ADI report. So until I see it and discuss it with our consultants, I really can't respond.

MS. SUREAU: I will get you one. I am sorry.

THE COURT: I think you will have it by the time you leave today if you stick around for a bit, and then perhaps you can tell me in the morning, at least by noon tomorrow. Thanks, we will see you at 9:00.

(Proceedings concluded at 5:04 p.m.)

C E R T I F I C A T E

STATE OF WASHINGTON)
) ss.
County of Pierce)

I, the undersigned Notary Public in and for the State of Washington, do hereby certify;

That the foregoing Verbatim Report of Proceedings was taken stenographically before me and transcribed under my direction; that the transcript is a full, true and complete transcript of the proceedings, including all questions, objections, motions and exceptions;

That I am not a relative, employee, attorney or counsel of any party to this action or relative or employee of any such attorney or counsel, and that I am not financially interested in the said action or the outcome thereof;

That I am herewith securely sealing this transcript and delivering the same to the Clerk of the above-entitled Court.

IN WITNESS HEREOF, I have hereunto set my hand and affixed my official seal this 14th day of May, 2004.

____
Notary Public in and for the
State of Washington, residing
at Tacoma.